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INVESTIGATION OF THE FINANCIAL CONDITION OF THE UNITED STATES

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COMMENTS OF OFFICIALS OF TRADE AND BUSINESS ASSOCIATIONS IN RESPONSE TO THE QUESTIONNAIRE

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

EIGHTY-FIFTH CONGRESS

SECOND SESSION

CHAPTER 4

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INVESTIGATION OF THE FINANCIAL CONDITION OF THE UNITED STATES

NATIONAL SMALL BUSINESS MEN'S ASSOCIATION,
Washington, D. C., April 25, 1958.

Senator HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: I enclose herewith 10 copies of our responses to your questions on the state of the economy enclosed with your letter of February 17, 1958.

As you know, the scope of these questions covers a tremendous area, and I do not know whether we have been able to make any noteworthy contribution. Nevertheless, we feel complimented that you have asked us to try, and we assure you of our heartiest cooperation and best wishes in your effort to maintain a sound economy.

Cordially yours,

HARRY E. BRINKMAN, *President.*

Enclosures.

REPLIES OF THE NATIONAL SMALL BUSINESS MEN'S ASSOCIATION TO QUESTIONS SUBMITTED BY SENATOR HARRY F. BYRD, CHAIRMAN OF THE SENATE COMMITTEE ON FINANCE

Question 1. Give a definition in your own words of deflation and inflation.

Deflation is ordinarily considered to be a sustained decline in the general price level. And inflation is ordinarily considered to be a sustained increase in the general price level. Price deflation and inflation are typically accompanied by monetary deflation and inflation. Monetary inflation is an increase in the money supply (cash and currency in circulation plus demand deposits times their velocities of turnover). Monetary deflation is a decrease in the money supply.

When the total money supply (including its velocity of turnover) changes disproportionately to changes in total physical output of goods and services, monetary inflation or deflation occurs with consequent changes in the purchasing power of the monetary unit.

Question 2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

Monetary inflation could have been avoided in the post World War II period if the money supply (including velocity) had expanded at the same rate as productivity. Here also, if monetary inflation had been controlled so would monetary deflation now be less likely to

occur. Price inflation and deflation as they are related to monetary inflation and deflation would also be under better control.

For example, if taxes had been higher in the immediate post World War II period, or, if expenditures of the National Government had been controlled adequately, and the Federal Government had retired debt to reduce the money supply, both monetary and price inflation could have been checked and a sounder base for postwar growth developed.

Thus the current monetary laws are adequate if they are correctly administered so as to avoid severe inflation or deflation. To control inflation caused by excessive wage increases, it is necessary to equalize the bargaining power of employees to that of the employer; e. g., in the automotive industry there are four active producers which negotiate independently, but one monopoly supplier of labor, the CIO–UAW. If equalization of the economic power of the seller of labor with the buyer of labor occurred, there would be much less price inflation taking place and consequently less probabilty of price deflation.

One legislative change suggested then is the equalization of bargaining power between labor and the business unit. The strength of the typical labor bargaining unit is so much greater than the typical business bagaining unit that annual wage increases greater than annual productivity increases result, and these, by necessity, cause price increases. Small business firms are particularly at a disadvantage in dealing with the large labor monopolies. The small business firm typically sells its product in the competitive market whereas it purchases its labor from a power monopolist. The financial resources of small business are limited compared to those of the typical international union with which it negotiates. Bargaining in terms of financial strength is therefore completely out of balance.

Additional factors which militate toward an inflationary bias for the Nation and which are not within the control of the monetary system, are (1) a tax system which exerts pressure toward debt financing and against equity financing, (2) price support programs such as those in the agricultural and mining industries, (3) budgetary deficits of the National Government, and (4) credit programs of the National Government.

Question 3. Comment generally on the monetary control policies of the Federal Reserve System as exercised within the following years: 1942–57. (You may wish to divide the period into parts, 1942–50 prior to the accord, and 1951–57.)

The monetary control policies of the Federal Reserve System in the period 1942–50 were subservient to Treasury policies. The Treasury was concerned with selling Government bonds and maintaining bond prices; and, by continuing low interest charges to keep interest expense as low as possible, the Treasury forced its policies on the Federal Reserve to the detriment of the economic control of inflation.

In the period 1951–57 the Federal Reserve returned to its traditional pre-World War II role. Bond interest rates and prices were permitted to fluctuate to reflect the Board's interpretations of current and future business conditions.

The period 1942–47 was the period in which the traditional economic tools of the Federal Reserve should have been actively used to slow down the inflationary erosion in purchasing power of the monetary

unit which was occurring. In that period consmer prices rose 51.8 percent.

The 1951–57 period appears to be a much more effective one in terms of controlling prices and maintaining the purchasing power of the monetary unit. In this period consumer prices increased 7.5 percent.

This appears to indicate that if the Federal Reserve Board of Governors has freedom to use it existing tools to regulate monetary and credit conditions the regulatory devices are adequate. It is realized, of course, that inflationary pressures were greater in the immediate post-World War II period than in the 1951–57 period.

Question 4. Beginning in August 1956 there was an increase in the Consumer Price Index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar.

The factors which contributed most to the decline in the value of the dollar during this 1956–57 period were:

1. An appreciable increase in personal incomes, particularly labor incomes, which enabled consumers to increase their spending considerably, hence, there was a strong and rising demand for goods and services;

2. The increase in the rate of production of goods and services was so nominal as to be insignificant;

3. However, the disproportionate increase in labor incomes as compared to the norminal increase in productivity made for increased production costs and price increases;

4. Consumer purchases through increased credit buying added to the potency of demand for goods;

5. An appreciable increase in the velocity or turnover of money in circulation added somewhat to the money supply.

Question 5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

The management of the public debt involves, basically, the manner in which the Treasury decides to refund maturing issues such as bills, certificates, notes, or bonds—whether such refinancing will be short-term or long-term and whether it will be funded through the banks or nonbank investors.

Because the supply of funds available for investment in debt paper is limited, it behooves the Treasury to conduct its financing in a manner which will minimize competition with the private sector of the economy. Accordingly, it would seem desirable to finance a greater portion of the public debt by long-term rather than short-term maturities. This would help to reduce impact on the money market as well as to provide a sounder base for financing new short-term debt in an emergency.

Moreover, if the objective of the Treasury is to stretch out its existing debt and finance more of it through nonbank investors, then logically tax rates on individuals and corporations must be reduced. In fact, since World War II, bank financing of the public debt has been a primary cause of inflation. To avoid any greater use of the banks and to stimulate greater private nonbank investing and capacity, the tax burden must be kept to the minimum and the tax structure redevised to eliminate or to minimize its detrimental effects on incentive and risk taking.

Question 6. (*a*) Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy in the United States:

1. Price stability.
2. Stability of production, demand, and employment.
3. Economic growth in production, demand, and employment.

(*b*) With respect to these three objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially during 1957.

(*a*) In order of importance these three objectives should be rated (3), (2), and (1). Growth in production, demand, and employment have typified the growth of America with its rising level of living. The rapid increase in industrial production of the Soviet Union makes it even more imperative that sound long-term growth be continued in the United States.

Price stability for periods of time can be achieved with (3) or (2) by control of the money supply and by appropriate credit controls. The administration, the Congress, the Treasury, and the Federal Reserve Board of Governors could achieve price stability during (2) or (3) by working together with this goal in mind. However, although price stability as referred to here means general price stability of many individual prices of goods and services, it is not to be expected or desired necessarily, that minor fluctuations will not occur in response to individual consumer demands in the short run.

(*b*) The most important trends since World War II with respect to these three objectives appear to be relatively full employment up to the end of 1957; a monetary demand increased by liberal credit expansion and low interest rates on long-term funds, both of which overstimulated capital expansion primarily during the latter 2 or 3 years and particularly in 1957; a rising trend of monetary prices of commodities as a group. In the last few years, however, the general rise in commodity prices clouded the fact that the prices of farm products were declining.

The index of prices of all commodities remained remarkably stable in 1957 only dipping 1.5 percent while the index of farm-product prices declined over 3.5 percent. The apparent overall price stability also was misleading in terms of prices of such metals as lead and copper, both of which suffered severe declines.

Expansion of installment and consumer credit and private debt during 1955, 1956, 1957 occurred faster than population increases and growth in national income.

In addition, wages increased at a faster rate than industrial productivity and resulted in wage-push pressure on the general price level. Since agricultural workers, salaried workers, and many nonunion workers did not share proportionate wage increases, product price increases served to reduce sales volume. For example, automotive producers virtually were forced to grant substantial wage increases to employees. In turn, such increases were passed on to the consumer. The average consumer did not get the same increase as automotive workers and therefore credit expansion was used to make up the difference needed in purchasing power to buy the automobiles. However, when this credit was exhausted by auto buyers, it could not

again be utilized without the passage of time. As a consequence, auto sales declined substantially.

The economic system is composed of many variables. Each can affect the price level, employment, and consumer demand. The logical economic policy, therefore, must be adapted to the existing circumstances. The goals of such policy should be relatively full employment combined with economic growth.

Question 7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

Comparison of official statistical data indicates that government spending, while influential at times on the level of economic activity, is by no means a primary force in economic prosperity or recession. For example, between 1953 and 1955, the gross national product increased by almost $29 billion whereas government spending decreased by $7 billion. There is little evidence to support the view held in some quarters that government spending has any substantial effect on the forces in the private sector on which real economic growth depends.

Government spending, whether at the national, State, or local level, must be financed through either taxation or debt. If it is financed through taxation, the assumption is that government can spend the money more efficiently and productively than the individual taxpayer—an assumption which has yet to be proven sound. If the spending is financed through debt by the National Government, the effect is almost certain to be inflationary with a subsequent further loss of purchasing power by all segments of our population.

Accordingly, the import of the question would seem to be whether government at the National, State, and local levels should increase its spending in an attempt, hopefully, to mitigate the current recession. If this is the intent of the question, then the answer must necessarily be in the negative. Alternatively, however, the enactment of legislation for reduction of income-tax rates over a period of future years would benefit all segments of our economy, both producers and consumers alike.

Question 8. Give your opinion of the effect on our economy of current Federal, State, and local taxation.

The present total burden of taxation at the National, State, and local levels is clearly too heavy. With over one-third of the national income channeled for the cost of Government, every effort possible should be made to reduce this percentage. Many economists and businessmen believe that total Government receipts—at all levels—should not exceed 25 percent of the national income, if economic growth within a free society is to be maximized.

Immediate steps should be taken by the Congress to establish a fiscal program which will:

1. Reduce tax rates on individual and corporate incomes appreciably over the next several years;
2. Develop a better balance in the tax system as between alternative types of taxation. For example, about 80 percent of net budget receipts of the National Government is from income taxation alone.

While numerous inadequacies could be cited regarding our present tax structure, particularly at the national level, the two suggestions noted above are singularly most important in terms of correction.

The rates of income taxation are a deterrent to economic growth and advancement because they reduce the incentives to produce, to save, and to invest; they cause a misutilization of time and resources of business; they foster taxpayer immorality.

Question 9. Will you distinguish between fiscal policy, embracing expenditures, taxes, and debt) and monetary and credit policy, and then relate them, one to the other. Please discuss these policies stating how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

Fiscal policy is public taxation policy and public expenditure policy as they relate to cyclical fluctuations and to employment and economic growth. If the Federal Government employs fiscal policy on a positive basis then taxation and public expenditure will be directed so as to reduce cyclical fluctuations and to stimulate employment and economic growth.

A positive monetary and credit policy is adjustment of the supply of money and credit (cash and currency in circulation plus demand deposits times their velocities of turnover) with a view to reducing cyclical fluctuations and to stimulate employment and economic growth.

The Federal monetary policy is administered by the Federal Reserve Board of Governors.

The fiscal policy is administered by the Congress, the Treasury, and the Bureau of the Budget.

The Federal Reserve in carrying out monetary policy can restrain inflation by raising the bank discount rate to member banks, raising stock market margin requirements, selling Treasury bonds in the open market, and increasing member bank reserve requirements.

In selling bonds the Treasury generally should lengthen bond maturities in prosperity and shorten them in recession. The antirecession and antiinflation policies of the Federal Reserve and of the Treasury must be coordinated in order for them to be effective. For example, the Treasury in selling a new money short-term bond issue in a recession would find extremely helpful a cut in bank reserve requirements by the Federal Reserve Board just prior to such sale. This would release funds for banks to purchase such an issue. In inflationary periods the Government should be balancing its budget as a minimum and preferably retiring already existing bond issues. If necessary, any sale of bonds in such periods should be to private investors, not banks. The Federal Reserve Board in such periods should keep member bank reserves tightened.

A sound fiscal policy should require adequate control over Government expenditures in order to avoid heavy taxation. The tax system should be so devised as to minimize its effect on incentive to produce, to save, and to invest. The inflationary effects of deficit financing can be avoided by keeping the budget within balance.

Question 10. (*a*) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purpose of this question consider that the monetary system includes bank deposits and bank credits.) Also please furnish your ideas for the correction of any inadequacies that you feel now exist in our monetary system.

(*b*) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

(*a*) The United States monetary system is basically sound and adequate.

(*b*) The fiscal system of the United States is inadequate for the following reasons:

1. There is no overall coordination within the Congress on budget, debt, and tax policies.
2. Within the Congress there is a complete absence of a set of goals or objectives which could be examined for future planning.
3. Specific objectives of fiscal policy in terms of evaluating expenditures with debt and tax reductions for a period of future years are nonexistent.
4. Income-tax rates are not conducive to economic growth.
5. The tax structure is too dependent on income taxation.

Question 11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy?

(*b*) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

(*a*) Inflation and unemployment do at times exist side by side. Wages in the period 1956–58 have advanced 4 percent even though unemployment has increased by 3.4 million. Raw material prices have increased 5 percent and consumer prices by 4 percent. The reasons are (1) continuation of wage increases in recession periods (some contracts made in 1956 and 1957 call for automatic increase in 1958); (2) wage rates are expanding faster than productivity rates as a result of the monopoly powers held by labor unions.

(*b*) Absolutely not. Fixed-income recipients such as retired people on pensions, and colleges and charitable institutions heavily dependent on fixed income securities, find the purchasing power of their income reduced; (2) Insurance beneficiaries find their dollar proceeds eroded; (3) Economic dislocations occur in imprudent business decisions; (4) The benefits of the inflationary policy go to monopolistic labor groups rather than to the consumer.

Question 12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy?

Between 1946 and 1956, total private debt increased from $171 billion to $456.5 billion. The latter figure is composed as follows (in billions):

Individual debt:	
Mortgage	$131.5
Consumer	41.9
Other	34.1
Total	207.5
Corporation debt	249.0
Total private debt	456.5

While it is true that total individual debt and corporation debt increased at a faster rate than national income, it does not follow necessarily that these debtors are incapable of carrying their obligations. Indeed, the preponderance of evidence is on the side of the American buyer in terms of paying his bills.

The rapid growth of corporation debt, on the other hand, is essentially the fault of the corporate income tax. This tax has a distinct bias in favor of debt financing over equity in that it allows interest as a deductible expense in determining net taxable income but prohibits a deduction for dividends. Moreover, if debt financing is encouraged through tax policy by penalizing business firms which would prefer to expand through equity capital, the economy is made increasingly vulnerable to a down-spiraling recession. Historical facts show clearly that no cumulative recession movement has ever developed because of a preponderance of equity capital over debt financing. Rather, only with debt financing can we associate the cumulative difficulties that the terms "insolvency" or "bankruptcy" bring to mind.

Accordingly, the income tax rates as a primary cause of debt do, indeed, become a threat to the stability and vitality of the American economy.

Question 13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy?

The question by implication presupposes that the "moves," or lack of necessary actions, which the Government has made, or not made, in former years has had a healthy effect on economic conditions, and that only if economic conditions were to worsen further would the Government take some direct action such as a tax cut or public works program.

Because unemployment has risen in recent months from a norm of 2.5 million to something over 5 million, pressures have mounted in several quarters, especially within Government itself, to focus primarily on the unemployment problem. From a political standpoint this is understandable, but in terms of economic consequences such ill-advised action is without logic and prudence.

Since the end of World War II, and particularly since the enactment of the Employment Act of 1946, virtually all segments of our society—business, labor, and Government—have discoursed at length on the need to do one thing—foster the economic growth of the Nation. Few people will quarrel with this objective. However, wide differences of opinion exist as to the actions needed to sustain economic growth.

One thing seems certain however. If the Nation's economy is to remain one based predominantly on competitive free enterprise, then the cardinal element of profit must be respected. No person or group of individuals will risk its savings to start a business enterprise or expand existing enterprise if they are not confident of realizing a profit.

If, then, we examine our economic environment in the light of this primary criterion, profit, we are faced with an almost certain conclusion—namely, that the economic policies of the National Government have not been conducive to a healthy business climate in terms of realizing profit. Whether by design or by blind allegiance to an unsound doctrine—progressive income taxation—the National Government has maintained policies which are in fact detrimental to consumers, labor, and business alike.

Moreover, the question suggests impliedly that a tax cut under current recessive conditions would counteract the downturn in economic

activity by increasing the purchasing power of consumers and that, accordingly, increased consumer spending would result. This, presumably, would stimulate production and, accordingly, increase employment. Therefore, it is argued that the Nation's immediate economic problem is one of increasing employment per se, and that the heretofore sound objective of economic growth can be set aside. Such reasoning is, in effect, to "put the cart before the horse."

The Nation's primary economic problem today is the same one which has existed since the advent of progressive income taxation—namely, the all-important need to establish and maintain an economic climate which is conducive to growth and advancement. As day follows night, this, then, requires that income tax rates, both personal and corporate, need to be reduced over a period of several years—not for the purpose merely of stimulating consumer purchasing power per se, but rather for the purpose of providing incentives to save, invest, produce, as well as spend. No move by the Congress could be as singularly important in fostering a climate conducive to economic growth and employment as this one.

It is difficult to perceive any wisdom in increasing public work projects to counteract the current recession.

Question 14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

Since World War II, deficit spending by the National Government was as follows:

Fiscal years:	*In billions*
1949	$1.811
1950	3,122
1952	4,017
1953	9,449
1954	3,117
1955	4,180
Total	25,696

Accordingly, total deficit spending in the period (1947–57) amounted to nearly $26 billion. However, in the same period there were 5 years (1947, 1948, 1951, 1956, and 1957) when there were budget surpluses, which amounted, in toto, to $16 billion. Thus, on balance there was a net total deficit of $10 billion. While a net total deficit of this magnitude, over 11 years, by itself, would indeed be considered inflationary, because of the intervening budget surpluses the volatility of the deficits from the standpoint of inflation was reduced.

However, about 24 percent of the deficits occurring between 1949 and 1955 were financed through the banks. While this figure by itself may not seem too high, it is three percentage points higher than the amount of gross debt which the commercial banks held at the end of 1956—which was considered at that time to be unduly large—at which time, incidentally, national income was significantly higher than the average for the period (1949–55).

In summary then, it appears to be rather conclusive that deficit spending since World War II has been a factor in contributing to inflation by exerting pressure on a tight money supply, which was during a period of our economic history when consumers were competing for relatively scarce goods and services.

Question 15. Can full employment goals be attained while maintaining a dollar that has relative stable purchasing power?

Over certain periods relatively full employment has been attained while the purchasing power of the dollar remained relatively constant. An example is the period 1953 to 1955 when the purchasing power of the dollar (1947–49=100) averaged as follows:

1953	87.4
1954	87.1
1955	87.3

From 1952 to 1956, the purchasing power of the dollar declined 2 points from 88.1 to 86.1. During this same period, the Nation experienced relatively full employment although the recession of 1953–54 with unemployment of 3.2 million out of a total labor force of 68.9 million (including Armed Forces) did occur.

As previously indicated, overall price stability may camouflage selective economic dislocations such as in agricultural prices or in certain raw materials which reflect international supply-demand changes. But, if Government restrictions including oppressive tax rates placed on business firms are held to a minimum, it seems likely that under our economic system relatively full employment can be attained along with a relatively stable dollar, providing, of course, that wage increases do not outrun productivity gains.

Question 16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

Escalator provisions in wage or other contracts may be compatible with achieving economic price stability to the extent that they represent real productivity changes. However, if they are improperly determined, such provisions can actually feed inflation and help to foster instability in the economic structure. Certain groups of strongly unionized employees could obtain escalator provisions that would force price increases or prevent price reductions in the products of their industry. If other groups did not experience similar wage increases, the result could be exploitation of employees in other industries such as agriculture, retired people, white-collar workers, and business firms particularly small business.

Question 17. List and briefly discuss what you consider the causes of the present recession and what should be done to terminate it.

It is difficult to say the least, to pinpoint the specific factors which caused the current recession. The causes undoubtedly are numerous and varied. Indeed, it seems probable that virtually all forces operating in the economy contributed in one way or the other to the current downturn.

However, it seems clear that the drop in demand in the durable goods industries had a distinct effect on the investment plans of business firms, particularly in the second half of 1957, which has also carried over into 1958; also, the falling demand was influential in the decision to reduce inventories at a rather alarming annual rate of $6 billion. In fact, the book value of trade and manufacturers' inventories dropped more in the month of January of this year than in the entire fourth quarter of 1957—a drop which is the largest since the June–July drop during the recession of 1954.

If one attempts to examine the reasons for the decreasing demand in the durable goods industries, attention is focused on costs and prices. On the cost side, the primary element, labor, has been mar-

keted at a rate faster than productivity. This has caused prices to increase at a time when constrainment was the guideline in monetary policy, which undoubtedly tended to reduce the availability of credit and increase its cost.

However, few people are prepared to say that the Federal Reserve Board's restraining monetary policy throughout most of 1957 was a primary cause of the current downturn, although, with the advantage of hindsight, an easing of credit in the summer of last year in all probability would have lessened the rate of inventory liquidation. To this extent, a more perfected statistical intelligence system would have enabled the Reserve Board to have acted with greater assurance and, hence, greater effectiveness. On the other hand, had the Federal Reserve Board not kept the check-rains on credit as long as it did, inflation would have been even more volatile; this would have cost the Nation in purchasing power probably many more times than the cost of the current decline. Moreover, it would undoubtedly have accentuated the ensuing economic dip even further.

Probably the most important factor toward sustaining economic growth and, accordingly, maximizing employment, is the necessity to reduce tax rates on individual and corporate incomes. The National Government's tax system is unquestionably a deterrent to the formation of capital, without which the economy cannot grow. If the population of the Nation's business entities, including individual investors, is dissuaded from producing, and saving for the purpose of investing in equities, it will be only a matter of time before even more serious economic dislocations occur.

Accordingly, the following suggestions are made in the interest of stimulating economic growth including the stimulation of its inherent component, employment:

1. Enact legislation which will reduce over the next several years, tax rates on individual and corporate incomes. This will stimulate the formation of capital, production, employment, consumption and, not the least of which will be the beginning of a rebirth of confidence and business initiative, the beneficial results of which are incalculable.

2. Enact legislation which will mitigate the monopoly powers of labor unions including their powers to increase costs.

3. Enact legislation which will provide for coordination, forward scheduling and planning of budget expenditures, receipts, and debt management. The establishment of such specific goals and objectives of fiscal policy would enable congressional committees and executive branch to evaluate current programs and operations in the light of these anticipated fiscal targets. This would provide guidance of a sort which is now virtually nonexistent.

ASSOCIATION OF AMERICAN RAILROADS,
Washington, D. C., March 10, 1958.

Hon. HARRY FLOOD BYRD,
Chairman, Senate Committee on Finance,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: As requested in your letter of February 17, which I acknowledged on February 18, I enclose my views on each of the 17 questions you have asked in connection with your inquiry entitled "Investigation of the Financial Condition of the United States."

Although the responsibility for these answers is my own, I have had a good deal of assistance from three members of our staff that I regard as outstanding in their field. They are Mr. J. Elmer Monroe, vice president and director of the bureau of railway economics; Mr. A. R. Seder, vice president, finance, accounting, taxation, and valuation department; and Dr. Burton N. Behling, economist, bureau of railway economics.

With kindest regards,

Sincerely,

WILLIAM T. FARICY.

1. Give a definition in your own words of "deflation" and "inflation."

To the layman, inflation and deflation are manifested, respectively, by upward and downward movements in the general level of prices and the cost of living. Especially if they are persistent over a considerable period of time, such movements of prices and costs bring about serious dislocations and imbalances in the economy because the price and cost changes do not occur evenly throughout the economy.

2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

Historically, the evidence is strong that inflationary factors and consequent maladjustments in the economy have within themselves the seeds of subsequent deflation. Inflation occurs when there is a disproportionate increase in the quantity of money and credit in relation to the goods and services available in exchange, and this excess exerts an upward pressure on prices and costs. Deflation is a corrective adjustment, to obviate which we must first prevent inflation. In recent years the emphasis in policy has been placed unduly upon full employment and economic growth, to the exclusion of due consideration for the importance of price stability. This makes for a bias toward inflation. The Employment Act of 1946 should be modified so as to recognize price stability along with full employment and economic growth as an important objective of national policy.

3. Comment generally on the monetary-control policies of the Federal Reserve System as exercised within the following years: 1942–

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57. (You may wish to divide the period into two parts, 1942–50 prior to the accord, and 1951–57.)

In the first part of this period (1942–50) too much attention was given in monetary-control policies to the pegging of Government bond prices and interest rates. Also, the costs of World War II were financed too much by borrowing, too little by taxation. These policies continued after the war and contributed substantially to the inflation which occurred in the immediate postwar period. The Treasury-Federal Reserve accord was an important corrective step in the direction of a more realistic Government fiscal policy, but it was too long deferred. Inflationary factors involving monetary policy in the more recent period are commented upon under subsequent headings in this statement.

4. Beginning in August 1956 there was an increase in the Consumer Price Index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

Continuing inflationary pressures were working their way progressively through the economy, spearheaded by wage increases in key industries in excess of productivity increases. Pressures to transmit such patterns to other segments of the economy, including the service occupations, increased and exerted widespread upward pressures on prices. At the same time, business capital expenditures aimed at eventual cost reductions and efficiencies also were increasing, exerting further immediate pressures on available economic resources. Under these conditions, resistance in the prosperous pattern industries to demands for increased wages and fringe benefits were not as strong as they should have been, as the prevailing view seemed to be that cost increases could be passed along in prices.

5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

Deficit financing by the Government, particularly when it involves "monetization" of the debt through the money and credit supply of the banking system, is basically inflationary. If this occurs at a time when other inflationary forces are active, the spiral process is accelerated. Essentially, money and credit supply should be the servant of the productive economy, responsive to its needs but not its attempted master.

6. (*a*) Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy in the United States:

1. Price stability.
2. Stability of production, demand and employment.
3. Economic growth in production, demand, and employment.

(*b*) With respect to these three objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially during 1957.

As previously stated under item (2) above, there has been too little emphasis in recent years on the basic desirability of price stability, which has been slighted in favor of the other factors of stability mentioned. Apparent economic gains which merely reflect price (and

cost) inflation are illusory and lead to maladjustments of the kind that have become so apparent in recent months. Shot-in-the-arm inflationary expedients can provide temporary stimulants but they are not themselves indicators of economic health. If we can maintain reasonably stable economic relationships, including price and cost relationships, economic growth will probably take care of itself through advancing technology and competitive enterprise.

7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

Currently, high levels of Government spending are helping somewhat to bolster a sagging economy. This should not be taken to mean, however, that Government spending in such circumstances is desirable for its own sake. One way or another the costs must be paid for and wasteful Government expenditures are no more to be desired in slack times than at any other. This word of caution seems particularly necessary now because of a rather general tendency to scrutinize less carefully than, say, a year ago proposed expenditures for Government undertakings in the civilian economy. Standards of sound economy in public works, for example, do not change with every shift in the economic breeze.

8. Give your opinion of the effect on our economy of current Federal, State, and local taxation.

Especially over the past 20 years it is well known that taxes have increased to ever higher levels, owing to war and defense costs, many extensions of Government functions, and inflated price levels. It is at least doubtful whether the health and vigor of our private economy, and its growth, can be maintained permanently under such heavy tax burdens as now exist. We may well be very skeptical, therefore, regarding assurances sometimes expressed that the Nation's productive economy will in time "grow up" to present or even higher levels of taxation.

Current high rates of corporate and personal income taxes, especially, are exerting a drag on business investment, venture capital and, hence, on economic growth. We can never afford to overlook the basic fact that profits and savings are vitally necessary to technological progress and growth in an enterprise economy. A corporate income-tax rate of 52 percent and individual income-tax rates reaching up to 91 percent cannot help but dry up private capital formation, dampen incentive and diminish economic efficiency.

Another consideration always to be kept in view is that in the final analysis taxation can never be judged apart from the Government expenditures for which the taxes are collected. Any tax, of whatever kind and at any level, is too high to the extent that its proceeds are used to pay for wasteful or unnecessary expenditures. In such circumstances, the taxpayers would make greater contributions to a sound economy if permitted to make their own expenditure decisions.

9. Will you distinguish between fiscal policy (embracing expenditures, taxes, and debt) and monetary and credit policy, and then relate them, one to the other. Please discuss these policies stating how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

To help restrain an inflationary situation the essential requisites of fiscal and monetary policy are, in general terms, rather clearly

indicated. An inflationary period would be a time for reasonable credit restraint and for debt reduction by maintaining existing tax levels while holding back postponable expenditures. In slack times, of course, reverse policies may be indicated for maintaining a stable economy. But while these general criteria of fiscal and monetary policy are clear, their application presents exceedingly delicate problems of timing and degree. One of the greatest dangers is that pressures will rather continuously be exerted in an upward or inflationary direction, responsive to apprehensions that unless such policies are pursued conditions for sustained, or even accelerated, economic growth might be insufficiently nourished. Such views seem to have been largely responsible for inflationary predilections in recent years, this being associated also, with the widespread attitude that the Federal Government must in some way underwrite or guarantee uninterrupted economic growth and prosperity. In this connection, we need to be aware of two considerations: (1) As a practical matter, it is not easy to invoke the disciplines necessary to check inflationary tendencies and allures; and (2) the influence of governmental actions designed to promote economic growth and stability is, at most, rather limited.

10. (*a*) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purpose of this question consider that the monetary system includes bank deposits and bank credits.) Also please furnish your ideas for the correction of any inadequacies that you feel now exist in our monetary system.

(*b*) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

With respect to (*b*) it may be pointed out again that the Federal tax system is too heavily weighted in the direction of high rates of income taxation. With respect to the expenditure side of fiscal matters, there is great need to impose fully compensatory user charges to recover the costs of facilities such as waterways. highways, airways, and airports from those who gain special advantages from their use. There is no equity in imposing such burdens upon general taxpayers and, moreover. this method of financing only encourages those seeking special advantages for themselves to press for uneconomic spending of funds taken from general taxpayers. The selection of economically sound public projects would be made much more certain if those seeking expenditures on their behalf knew they would have to pay the costs.

11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy?

(*b*) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

With respect to the first question, the concurrence of inflation and considerable unemployment is both unusual and disturbing. The condition has developed from repeated increases of wage costs in excess of increased productivity, with the result that prices have been pushed upward where possible to meet the advancing costs and, where this has not been possible, measures have necessarily been taken to economize on the use of manpower. This represents an unhealthy situation from the standpoint of workers, of employers, and of the economy generally.

As to the second question, acceptance of a gradual inflationary trend as either desirable or inevitable is a dangerous escape from realities. While some elements of the economy may gain special advantage for themselves under such conditions, temporarily or even for considerable periods, many others are the unfortunate victims and especially those least able to protect themselves from the inflationary onslaughts. At bottom, persistent inflation is an insidious way of redistributing shares in the national income. Even an apparently modest inflationary push of 2 or 3 percent a year would amount to a very serious cumulative depreciation in the value of money over a period of 10 or 20 years.

12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy.

Our economic system has become progressively more reliant upon credit with respect to both production and consumption. To a very substantial extent the resulting debt structure reflects the creation of bank credit money rather than the accumulation of actual savings borrowed from others by the debtors. While debt formed through the bank credit process is a powerful expansionist factor in a growing economy, and hence contributes to its vitality in this respect, there also are very real dangers of excessive debt built up in this way. A threat to economic stability arises in that the accumulation of debt through the bank credit process may be too great during expansion or boom periods when optimism is high.

This appears to have been the case in recent years, for example, with respect to the rapid growth of consumer debt that has occurred. This process of financing growth through debt cannot go on without limit and the debt burden may become serious during an economic downturn such we are now experiencing.

It would be better for the economy, since excesses and inflationary tendencies would be less likely to occur, if debts were supported to a greater extent by actual savings rather than the creation of credit money through the banking system. There may also be a significant connection between our increasing reliance upon bank credit money and existing heavy burdens of income taxation which inhibit savings as the basic source of sound credit.

13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy.

This is a difficult question to answer in terms of "what point" because there are so many conditions that enter into a comprehensive judgment. Considering the unfavorable budget outlook and the large existing debt of the Federal Government, hasty measures for large tax cuts or enlarged expenditures for public works should be avoided, while watching over the next several months to see whether the economy gathers strength or grows weaker.

If the time does come when major counteracting or restorative measures by the Government seem clearly indicated, preference should be given to tax cuts rather than major increases in public works. The stimulative effects of tax cuts are likely to be more immediate, whereas public works programs are slow moving. Morover, emergency public

works measures encourage waste and inefficiency in the selection of projects of dubious economic merit.

Meanwhile, since the revenue losses to the Treasury would be moderate and because their particular levies are a drag on the whole economy, immediate consideration should be given to repeal of the existing transportation excise taxes on freight and personal travel.

14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

Without attempting to state the matter in quantitative terms, which in any event would be impossible to do precisely, deficit spending by the Federal Government has been a significant, though not the only, factor contributing to inflation since the end of World War II. Lax fiscal policies, tied in with loose monetary and credit policies, were especially conducive to inflation in the immediate postwar years. Budget surpluses, reduction of the Government debt, and credit restraints were not sufficiently pursued. As previously noted, widespread and repeated rounds of wage increases in excess of growth in productivity, followed by price increases, have added to the inflationary spirals, with only occasional interruptions since World War II. In all of this there has been the persistent illusion that prosperity is measured by rising money wages and money incomes, whereas, basically, economic well-being depends upon what is created and produced in capital and consumption goods and services. In brief, as a Nation, even as we have talked about the evils and consequences of inflation, we have continued to indulge rather freely in it.

15. Can full employment goals be attained while maintaining a dollar that has relative stable purchasing power?

Yes, we can have full employment while maintaining a dollar that has relatively stable purchasing, although it must be recognized that some fluctuations will occur in both in a complex and dynamic economy. In the past there have been long periods of economic growth, prosperity, and reasonably full employment while the dollar has remained stable or when general price levels have even trended slightly downward.

Instability in the purchasing power of the dollar introduces an undesirable speculative element into all forward planning by business and industry, especially with respect to capital investments and their financing. Problems of individual and family finance also are subjected to the same uncertainties. Money then fails in one of its most basic functions—that of providing a standard of value over a period of time.

Rather than assuring continued economic growth and employment, persistent inflation inevitably generates dislocations in the economy that eventually lead to unemployment and associated economic distress. The notion that creeping inflation is a desirable stimulus to the economy is a devious way by which some obtain a greater share of total national income, at the expense of other segments and groups in the economy less fortunately situated. Eventually, when distortions and dislocations have become sufficiently aggravated, corrective forces set in which entail economic loss to the whole economy, and real suffering to many.

16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

Escalator provisions in wage or other contracts are not compatible with achieving economic stability. They are built-in factors which tend to sustain inflationary price movements, regardless of productivity. If we imagine conditions where all prices and costs contained automatic escalator provisions, the stage would be set for permanent and progressive inflation, with all such provisions chasing each other upward in an endless cycle of actions and reactions. Even when contractual escalator provisions exist in only certain sectors of the economy, as in the case of wage rates in certain major industries, they exert upward pressures on other prices and costs far beyond their immediate impact.

17. List and briefly discuss what you consider the causes of the present recession, and what should be done to terminate it.

The present recession is a culmination of certain excesses of an inflationary character in the postwar period for which the Government, organized labor and business interests are all in part responsible. There have been preachments against inflation while at the same time policies were pursued that were inflationary. The result has been a persistent though uneven uptrend of costs and prices, fed by liberal credit policies intended to foster continuous and accelerated economic growth by providing increased money incomes.

Now this bootstrap operation has faltered and we are passing through a period of corrective adjustments. There are not yet, at least, indications that we have entered into a cumulative series of declines and, therefore, precipitous actions by the Government of a counteracting nature would not seem to be called for. In most respects, the economy is still operating at high levels as compared with most periods in the recent past. Alarmist appeals for a resumption of inflationary tactics should be resisted, for in basic terms of resources and technology our economy remains strong and is not crumbling. Increased wages, costs and prices in the midst of declining economic activity certainly cannot be regarded as constructive or remedial. There is reason to believe that the regenerative powers of our economy will soon arrest the present declining phase if these constructive forces have reasonable opportunity to be asserted.

WILLIAM T. FARICY,
Chairman of the Board and Chief Executive Officer, Association of American Railroads, 915 Transportation Building, Washington, D. C.

MARCH 10, 1958.

NEW YORK STOCK EXCHANGE,
New York, N. Y., April 1, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: In supplementing my letter of February 24 in connection with the Finance Committee's inquiry entitled "Investigation of the Financial Condition of the United States," I have used, as you suggested, the list of questions submitted with your letter of February 17 merely as a guide. My remarks pertain particularly to questions 2, 6, 8, 9, 12, 13 and 15, and as they relate specifically to the investment process in which we have perhaps some special knowledge.

Events since the end of World War II have shown the crucial importance of capital investment to economic stability and growth. Business outlays for plant and equipment have been at record levels since 1946. Employment in the same period has been extremely high and has shown remarkable stability. This relationship is not accidental. Over this period, investment expenditures have not only meant the employment of labor to make capital goods, but have also generated higher incomes, which expanded demand and jobs in consumer goods industries. At the present time, the result of a sharp decline in capital spending is evident in the current recession.

Despite the fact that the large volume of investment since World War II boosted industrial capacity, it has not been sufficient to modernize and improve the efficiency of much of our industrial facilities. Because we have actually fallen short of our investment needs in the postwar period, inflation has dominated the economic scene. Wage increases have exceeded rises in productivity. Our fixed income population—the teachers, pensioners, Government workers—have suffered evaporation of their purchasing power.

Our competitive position in world markets has weakened, while other nations have pointed the way to wise economic progress. West Germany, for example, has adopted fiscal policies to stimulate investment—and has led the free world in its rate of economic growth—without inflation.

Thus if we are to grow soundly, the future calls for greater plant and equipment expenditures to dampen latent inflationary pressures with an increase in the flow of goods, manufactured at lower cost under conditions of rising productivity. Greater business investment in capital goods is the key to achieving what should be the prime economic objectives of our time: steady, continuous growth in production, demand, and employment—with price stability.

As President Eisenhower has pointed out, "* * * investment outlays contain the promise of greater national output and better living in the years ahead." Merely to continue our past rate of growth will require vast capital outlays. A growing population calls for an ever larger flow of capital goods just to maintain our present standard of living.

To satisfy the future demand of the American people for a constantly increasing supply and variety of consumer goods will require an enormously stepped-up rate of investment. An increased stock of productive capital goods, at the same time, will provide jobs for our expanding labor force—and at higher wages. Besides making maximum employment possibly, highly productive capital equipment, by increasing output per man-hour, will limit the recent tendency of wages to outstrip labor productivity.

It is my firm conviction that we have fallen short of our investment needs and, consequently, our economic objectives because we have penalized savings—the source of investment funds. We have reduced too much the incentive to invest. High personal income taxes, double taxation of dividends, and capital gains taxation have discouraged thrift and reduced the flow of savings available for business investment.

Tax discrimination against equity investment has caused business to rely heavily on debt financing—a situation of increasing concern. Corporate debt since the end of World War II has accounted for about 80 percent of external financing. An important reason for this emphasis on debt is favored tax treatment of interest charges, compared with dividend payments. As a result, corporate debt has more than doubled—up to $130 billion—since the end of 1945. If postwar financing trends continue, corporate debt will probably rise another 50 percent by 1965. In this respect, governmental policies should provide more incentive for common stock financing.

Although the buildup of debt may not yet have become excessive or dangerous, the heavy weight of corporate obligations has reduced business flexibility in periods of economic decline. Many small firms have jeopardized their future by heavy reliance on debt financing. The absence of an adequate equity base has hampered the expansion of many firms, particularly the smaller companies.

Encouraging business to expand investment—via a healthy financial structure—and providing individuals with incentives to save and invest will, I believe, eliminate a principal cause of irregularities in the business cycle.

The New York Stock Exchange has estimated that corporations alone will need $350 billion for new plant and equipment between now and the end of 1965. In my opinion, adoption of the following tax program would energize the flow of venture capital and move us toward the goal of meeting these capital needs:

(*a*) A substantial reduction in the high progressive rates of personal income tax.

(*b*) Further reduction of the unfair burden of double taxation of dividends.

(*c*) Cutting the capital gains tax in half by requiring only 25 percent of any long-term gain on a capital asset to be included as income.

(*d*) Reducing the capital gains holding period from 6 months to 3 months.

(*e*) Increasing the present maximum capital loss offset from $1,000 to $5,000.

(*f*) Allowing the individual taxpayer—at his option—to sell stock on which he has a long-term capital gain, without incurring an immediate tax if he fully reinvests the proceeds in a single stock investment within 30 days.

Although he is the one who ventures his funds in the first place, the risk taker—the investor—often has been forgotten. For example, in 1957, while labor income was 65 percent higher than in 1950, corporate profits were 7 percent lower. Individuals must have greater incentives to save. Increase the potential rewards of those risking equity funds and venture money in adequate volume will be forthcoming to finance business expansion.

In addition to this tax program, business must be permitted to earn enough, after taxes, to pay the investor a fair return on his money. Regulatory agencies must give a higher priority in their thinking to this need. Depreciation charges allowable for tax deduction should be increased and the corporate rate cut.

The adoption of a sound tax policy designed to encourage equity investment would, in my opinion, do much to smooth out the future pattern of economic growth. I believe a joint congressional-citizens committee, along the lines of the Hoover committee, should be appointed to review our entire Federal tax structure.

Speaking more generally, I believe that the Full Employment Act of 1946 should be amended to include stable prices as a goal. We should not accept a gradually inflationary trend as desirable or necessary to achieve and maintain full employment.

Certainly governmental deficits have contributed greatly to inflation. The Congress, therefore, should make greater effort to cut nonmilitary expenses—the Hoover Commission report makes many valuable suggestions in that connection.

I believe that in the period 1951–57 the Federal Reserve Board has acted with courage and foresight in their exercise of general credit controls. We have seen that the Board can—by applying general credit controls—effectively regulate the overall flow of credit or money in the economy, thus limiting inflationary pressures.

The Board also exercises selective control, taking the form of initial margin requirements to prevent "the excessive use of credit for the purchase or carrying of securities." In April 1955, these margin requirements were set at 70 percent and remained at that level until January 1958, when they were reduced to 50 percent. During this period, the exchange community believed that it was the Federal Reserve's general credit control policy and not the selective credit control of margins that restrained stock market credit so effectively. General credit controls acted as an effective brake on credit flowing into the stock market and tended to make high margins largely superfluous as a credit weapon. With margin requirements now at a more normal 50 percent, it is hoped that the Board will rely on general controls to restrict stock market credit in the future.

I have not discussed possible causes and cures of the present recession because that is a big subject by itself. Suffice it to say that we should not take hasty, ill-considered short-term steps which would weaken the Nation's bright future prospects.

Sincerely yours,

G. KEITH FUNSTON.

NATIONAL EDUCATION ASSOCIATION,
Washington, D. C., April 14, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: I am grateful for the opportunity to contribute to your inquiry entitled "Investigation of the Financial Condition of the United States." All too frequently otherwise sound investigations and treatises on the Nation's economy fail to account for the role that an educated people play as consumers, managers, skilled workers, and investors. Hence, I would prefer to address my remarks to a more limited phase of the inquiry; i. e., the financial condition of the United States as it is affected by and as it affects public education.

PUBLIC EDUCATION AND ITS CONTRIBUTION TO ECONOMIC GROWTH

The long-term economic growth of our Nation depends largely upon increasing the effective combination of labor, management, and wealth. Further gains in real national output as distinguished from inflationary increases will come from these three factors: (*a*) increasing the skill and educational level of workers; (*b*) improving productive plants and machinery; and (*c*) improving business organization, management, and labor relations. The quantity and quality of education available to pupils in the public schools is basic to the upgrading of all three factors.

There is considerable evidence that the educated person is better equipped to contribute to the Nation's economic and social growth. Recent studies have shown that the number of jobs available for unskilled workers is decreasing with the increasing technological development of the economy. A recent Bureau of the Census study entitled "Educational Attainment of Workers; March 1957" found that unemployment was more prevalent among workers with little education than among workers with high school and college educations. The unemployed had completed a median of 9½ years of schooling, while the employed in the labor force had completed a median of 11½ years.

Our plans for economic and technological growth are necessarily and inevitably tied in with—implemented or delineated by—the level of education and skills of the consumer-producer citizen. The pace at which the level of education attainment of workers is raised should be geared to much of our economic planning.

It is unwise long-range economic policy for the Nation as a whole or for the individual States not to invest adequate amounts in the public educational program—in adequate classroom facilities and in teachers' salaries which are high enough to compete with the salaries of college graduates in other fields.

We are currently suffering from complacency with our fine American system of education. Recent spectacular advances in education in other parts of the world have dramatically revealed two things: (*a*) the deficiency of our economic investment in education; and (*b*)

how an adequate investment can over a period of years reduce an educational deficiency in the labor force. Unfortunately, economic gains from the money invested in the education of first-grade pupils will not be realized until they enter the labor force some 12 to 20 years hence. But losses because of failure to invest now are not recoverable.

COSTS AND SUPPORT OF PUBLIC EDUCATION

Progress toward a strong and sound economy to undergird our continued progress as a free nation is inevitably tied to the support of an adequate educational system. Our financial investment in education is a key to economic growth. The determination of the program and the level of support have been left largely to State and local governments. This is in spite of the fact that our States' educational resources are pooled into national efforts both in time of peace and in time of war.

The total cost of public and private education for kindergarten through higher education is estimated at $19,763 million for the school year ending 1958. Educational expenditures for current expense, interest, and capital outlay have increased largely through State and local efforts. The increase for public elementary and secondary schools has been from $2,870 million in 1946 to an estimated $12,884 million for 1958. Part of this increase is inflationary. School bond rates have increased approximately 120 percent since 1946. Building costs are up 79 percent since 1946. The calendar year average salary of the instructional staff member has increased from $2,080 in 1946 to $4,450 for 1957. By contrast, two-thirds of the men in the labor force who were college graduates had an income of $6,000 or more in 1956. Part of the increase in costs is not inflationary. From April 1940 to March 1957, 2½ years have been added to the median educational attainment of the labor force, 1.2 years since 1948. Since 1946 there are 10,209,000 more pupils in public schools and 462,303 more teachers.

For the Nation as a whole the responsibility for public elementary and secondary schools, however, is shared by the three levels of government with 55.8 percent of current revenues from local sources, primarily the property tax; 40.6 percent from State sources, primarily sales and income taxes; and 3.6 percent from Federal sources. Since education undergirds our real economic advancement, the losses because of failure to finance adequate public schools are shared by the Nation as a whole.

All public-school expenditures are ultimately paid from tax revenues, largely those of States and local governments. Annual current expenditures are met by current tax revenues of school districts or by appropriations from the State and (to a small extent) from the Federal Government. The payment of capital expenditures from tax revenues is largely deferred by school districts, by the issuance of bonds which are a first obligation on the local tax revenues. These bonds are then retired over a period of years from local tax revenues.

The workability of this system of capital financing is currently threatened by high interest rates and congestion in the tax-exempt bond market. This comes after a decade of increased construction and borrowing activity with no period of diminishing activity in sight.

School-bond yields, even with the attractive tax-exempt interest feature, have been forced to move closer to the yields of non-tax-exempt securities to attract investors. In 1946, high-grade tax-exempt bonds, including school-district bonds, were 0.89 percentage points below corporate bonds of the highest grade. By 1957 these tax-exempt yields were only 0.29 percentage points below the corporate bonds.

It is hoped that your committee will give attention to the precarious state of capital financing of public-school plants. Questions are raised here of how public education can compete in the money market with private borrowers in times when, partly by Government action, the supply of money is limited. Educational needs frequently cannot be deferred until the school districts can afford to borrow. Hence, many school districts borrow at high rates—the payment of the principal and interest of which may jeopardize the future of the educational program should economic conditions reverse.

IMPLICATIONS OF A RECESSION OF THE PUBLIC SCHOOLS

Public education approaches the current recession with a backlog of needed construction of approximately 142,300 classrooms in the fall of 1957, and an estimated need for 132,800 by the fall of 1958. Even in prosperous times, we have failed to achieve an adequate supply of classrooms and a balanced supply of trained teachers. The situation is further complicated because of the following factors: (*a*) The high percent of fixed expenditures for debt service; (*b*) the increased legal obligations of school districts for salaries, attendance, and school programs; and (*c*) enrollment increases extending as far in the future as the forecasters have ventured.

On the local level the property tax is relatively stable, slow to increase in times of economic prosperity and slow to decrease in recessions or depressions. The property tax is levied on the assessed valuation of real and personal property, but the bulk of the tax falls on real estate. We have yet to test the stability of the property tax in a recession with the present situation in home financing—many postwar communities are composed of heavily mortgaged homes.

We cannot assume that the property tax will be as stable in future recessions as it has been during past recessions. Should real-estate values fall during the recession, a decrease in assessed value of real estate at this time would put many school districts over both debt and tax limits and leave a large share of the decreased revenue committed to the payment of existing bonded debt.

Capital outlay and interest in 1957–58 were estimated at approximately 25.9 percent of current school revenues as compared with 6.5 percent in 1946. A decrease in revenues at this time would necessarily result in curtailing the educational program of some schools in order to meet fixed obligations for the payment of principal and interest on debt unless help will be forthcoming from other sources. The school debt outstanding at the end of the school year 1946 was 66 percent of annual current school district revenue as compared with 93 percent in 1956.

Sources of State school funds are largely sales and gross receipts taxes and corporate and personal income taxes. Sales-tax receipts immediately reflect increases or decreases in the volume of purchases.

In 1956, according to the Tax Foundation, general and selected sales and gross receipts taxes contributed over 70 percent of the total tax collections in 16 States and over 50 percent in 36 States. In 1957 the sales and gross receipts taxes contributed 57.8 percent of total State tax collections. The current recession has already resulted in decreased income- and sales-tax collections, notably in Michigan, Delaware, and the District of Columbia. According to Business Week of February 15, 1958, Delaware is having to resort to short-term borrowing, and Michigan has been forced to hold up payments to school districts. According to a report in the Washington Post and Times Herald of Thursday, April 10, 1958, the District of Columbia finance officer reported that the sales-tax collections for 1957 were off about 8 percent.

The resources of school districts, even with State funds, have been under strain for the past decade to meet costs of increased enrollments; to keep up with an adequate supply of teachers and classrooms; and to expand the program to meet the advanced educational needs of the economy. For continued economic growth we must increase our public educational effort. With the existing system of public-school finance, it will be impossible for us to maintain our present educational standards (let alone improve them), should the recession move deeply into our economy.

Cordially yours,

SAM M. LAMBERT,
Director, Research Division.

NATIONAL ASSOCIATION OF MANUFACTURERS,
New York, N. Y., April 17, 1958.

Hon. HARRY F. BYRD,
Senate Office Building,
Washington, D. C.

DEAR SENATOR BYRD: We appreciated the opportunity to give our answers to the questions you raised in connection with the investigation of the financial condition of the United States. I understand copies of our answers have been filed with your committee. I hope they will prove of assistance to you and to the members of your committee.

We have been greatly interested in the progress of your study. Once again you have provided constructive leadership, as you have done on so many previous occasions to the benefit of all of us. I can assure you that your efforts and activities are greatly appreciated and recognized as being in the public interest.

Sincerely yours,

MILTON C. LIGHTNER.

REPLIES OF THE NATIONAL ASSOCIATION OF MANUFACTURERS TO QUESTIONS SUBMITTED BY SENATOR HARRY F. BYRD, ON BEHALF OF THE SENATE COMMITTEE ON FINANCE

Question 1. Give a definition in your own words of inflation and deflation.

Answer. Inflation is an upward movement, which may be sudden or gradual, of the general price level, separate from the advance of individual prices produced by specific conditions of demand and supply. Basically, the cause is an increase of the money supply (times turnover) disproportionate to the volume of available goods and services. This increase of the money supply may occur before the price rise—as in the case of deficit financing; or it may occur after the rise and with a view to validating it—as in the case of wage and cost increases at rates faster than the growth of national productivity.

Deflation is a downward movement, which may be abrupt or gradual, of the general price level, separate from the decline of individual prices produced by specific conditions of demand and supply. Basically, the cause is a relative deficiency of money supply. This deficiency may result from a loss of money supply—as in the bank failures of 1930–33; or from a failure to keep the money supply increasing in step with the expanding output of goods and services.

As used here, the term "money supply" includes currency outside banks, and demand deposits of business and individuals. The total leverage of money on prices involves also the velocity of circulation of demand bank deposits.

Question 2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

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Answer. In the light of the definitions and explanations given as the answer to question 1, it would be self-evident that inflation and deflation could best be avoided by maintaining general price level stability. This involves regulation of the money supply so as to finance the transactions of the people and the Government as the economy grows, without letting the total money supply increase or decrease enough to cause either inflation or deflation, respectively, as indicated by general prices.

The authority to control the supply of money and credit is now exercised by the Federal Reserve System, which was established in 1913. The System's control is not applied directly to the money supply as such, but indirectly through its control over the capacity of the member banks to create deposit credits by making loans and investments. The key point of this control is the legal reserve which member banks are required to hold against their demand deposit liabilities. When an inflationary trend is evident, the Federal Reserve Board can restrain credit expansion by putting pressure on bank reserves, and when a deflationary trend is evident, credit expansion can be encouraged by easing off on the reserve restrictions. Federal Reserve policies of credit restraint are more likely to be effective in curbing inflation than those of credit ease in resisting deflation. The reason is that the demand for credit continues during an inflationary trend despite the restraint, but, if a deflationary trend prevails, the slackening demand for credit may not be effectively revived at once by easier credit terms. The shift from restraint to ease requires more sensitive perception and greater accuracy of timing than the shift from ease to restraint.

If there were complete flexibility within the economy, the monetary and credit control vested in the Federal Reserve System would be reasonably effective in resisting inflation. But strongly inflationary conditions have been allowed to develop which are beyond control through monetary measures. These conditions are built-in commitments to inflation in fields other than that of money and credit. Examples are: Policies and practices of labor unions which enable them to obtain wage increases at a rate faster than the growth of national productivity, farm and mining price supports, Federal credit programs, large Federal budgets with their risk of inflationary deficits, a tax system which gives the advantage to borrowing (as against equity financing) for meeting the financial needs of business, and so on.

The Federal Reserve Board is powerless to deal with these situations. Price rises brought about by these commitments to inflation cannot be reversed by any application of money or credit policy. If the Board were to attempt to restrain the upward push on prices resulting from these causes by reducing the money supply and restricting the availability of credit, the eventual result would be a decline in business volume and a reduction in employment.

This is precisely what happened last autumn. The Board shifted from credit restraint to ease in the fourth quarter of 1957, not because the danger of inflation was past (prices are still going up), but because the policy of restraint was operating to curtail activity rather than to lower prices.

With respect to legislation, the emphasis should be against any laws or amendments that would impair the Federal Reserve System's

powers as the monetary control authority or interfere with the efficient discharge of its responsibility in this area. The steps that must be taken to restrain an inflationary impulse may often come under public attack and the System may possibly be blamed for a recession which, for the reasons noted above, was beyond its power to prevent.

The built-in commitments to inflation comprise an area in which statesmanlike action would render the System's task of inflation control easier and more effective. A legislative program for dealing with the more important of these commitments is suggested in the answer to question 17.

Question 3. Comment, generally, on the monetary-control policies of the Federal Reserve System as exercised within the following years: 1942 to 1957. (You may wish to divide the period into 2 parts, 1942–50, prior to the accord, and 1951–57.)

Answer. In this answer, the period is divided into two parts; namely, before and after the accord. For reasons that will appear later, the year 1947 marks a significant division point in the first part.

The keynote of Federal Reserve monetary-control policy for World War II financing is in the following statement in the Board's annual report for 1941:

"The System is prepared to use its powers to assure that an ample supply of funds is available at all times for financing the war effort and to exert its influence toward maintaining conditions in the United States Government securities market that are satisfactory from the standpoint of the Government's requirements.

"Continuing the policy which was announced following the outbreak of war in Europe, the Federal Reserve banks stand ready to advance funds on United States securities at par to all banks."

Early in the war, the Federal Reserve Board found itself wrestling with a series of conflicting and wholly contradictory policy objectives. These were:

(1) To make available at all times an ample supply of funds for war financing.

(2) To cooperate with the Treasury in maintaining prices and yields on Government securities close to the existing level for the duration of the war. The interest-rate pattern agreed on in 1942 was a range from three-eights percent on Treasury bills to 2½ percent on long-term bonds.

(3) To supply the banks with adequate reserves to enable them to purchase such amounts of Government securities as the banks were called upon to take.

In opposition to these objectives, which were definitely inflationary, the Federal Reserve authorities and the Treasury attempted a losing fight against inflation. The Board expressed this as follows:

"To resist inflation by joining with the Treasury in coordinated efforts toward the objective to derive the largest possible amount of funds from current income and savings and to depend on the banks as little as possible."

From the long-run standpoint as well as that of immediate war costs, inflation control was the most important objective, but this was the weakest part of the program. Despite the introduction of consumer-credit control under regulation W, resort to consumer-goods rationing, materials allocation, renegotiation, and excess-profits tax,

the successive annual reports of the Federal Reserve Board noted that inflationary pressures continued to increase. The rigid, low-level pattern of interest rates, a policy dictated by the supposed political need to hold down interest cost on the debt, was less successful in drawing on private income and savings than a different interest policy might have been, and the banks continued to acquire ever larger amounts of war-debt paper. At a time when the Federal Reserve Board should have been absorbing excess credit and purchasing power by open-market sales, they were obliged, on the contrary, to increase bank reserves by open-market purchases so that the banks could buy more debt paper. In April 1943, on the Board's recommendation, Congress provided that no reserves be required against United States deposits arising out of war loans.

The act of June 12, 1945, reduced the minimum Federal Reserve bank gold reserve against notes and deposits to 25 percent, instead of the requirement of 40 percent for notes and 35 percent for deposits which had prevailed from the beginning. This act extended indefinitely the authority to use Government obligations as collateral security for Federal Reserve notes, and it terminated the authority to issue Federal Reserve banknotes. It also terminated the authority of the President and the Secretary of the Treasury, under the Thomas amendment of May 12, 1933, to inflate the currency by issuing United States notes.

The broad outlines of this part of the story are clear, without further details. In substance, the Treasury was the chief architect of war-finance policy, and the Federal Reserve System had the secondary role of assistant. There is no evidence in the Board's annual reports of serious disagreement with, or resistance to, Treasury aims and intentions. Even while clearly realizing the dangers of inflation, the Board was not able to employ its monetary and credit controls to curb the trend.

After the war, there appeared the first intimations of the Board's desire to regain its independence and a release from Treasury domination. In its report for 1946, it noted that postwar monetary policy would need to be closely related to public-debt management, and listed the following problems:

(1) An overly large money supply.
(2) A vast public debt.
(3) Extensive holdings of debt in the banking system.
(4) The existing structure of interest rates.

The 1946 report declared that the Federal Reserve System would need to regain control over the volume of credit and to exercise some measure of flexibility in credit policy. But its thinking did not yet go all the way, for the objective just stated was followed by the qualification—"while maintaining the low cost of debt service and continued stability in the Government securities market."

In 1947, the Board was still trying to find a way to control inflationary credit expansion without abandoning support of the Government securities market. Since these horses were galloping in different directions, riding both of them at the same time was, indeed, a difficult feat. Finally, in July 1947, the first important step was taken by discontinuing the buying rate on Treasury bills. Thereafter, the rates on bills and certificates of indebtedness rose. Through 1948, the

Board sought to cope with mounting inflationary pressures by accepting cash for maturing securities, increasing bank-reserve requirements, reimposing consumer-credit regulation, and raising the margin rate for loans made to buy or carry securities.

With the downward trend in business activity, employment, and prices that appeared early in 1949, the Board's emphasis in credit policy shifted from restraint to ease. Successive reductions in reserve requirements were made during the year. In June of that year, the Open Market Committee announced:

"It will be the policy of the Committee to direct sales, purchases, and exchanges of Government securities with primary regard to the general business and credit situation. * * * Under present conditions, the maintenance of a relatively fixed pattern of rates has the undesirable effect of absorbing reserves from the market at a time when the availability of credit should be increased.

After this statement, the Board stopped the practice of making Government bonds available on demand, to avoid absorbing funds from private borrowers.

Toward the end of 1949, the signs of economic improvement led to modification of the policy of credit ease. The restrictive policy carried through the first half of 1950. Then the Korean war broke out, and the inflation threat increased, but the Board and the Open Market Committee announced that they were prepared to use all means at their command to restrain further expansion of bank credit consistent with the policy of maintaining orderly conditions in the Government securities market. Accordingly, credit requirements were progressively tightened—rediscount rates were raised, and the Open Market Committee conducted its operations so as to make it less attractive for banks to sell short terms to make loans and investments. But the old dilemma persisted. The credit-restrictive measures were offset by purchases of securities, mainly to assure successful refunding of matured or called securities and, to some extent, to maintain a stable market for long-term bonds.

Here is an example of a dilemma which is likely to recur in the future. When large refundings must be made in a boom period, monetary ease is damaging for the economy but essential for successful refunding. This assumes, of course, that bank support will always be necessary in refunding operations. Such will be the case unless the refunding terms are sufficiently attractive to nonbank investors. But this raises a point dealt with in the answer to question 5 namely, Treasury diversion of funds from the private, long-term market. The politically inspired idea of saving on interest charges has cost the people many times more than the interest in inflation. This will continue, and the refusal to make income-tax rate adjustments whereby savings can be increased will aggravate the condition still further.

The showdown on Treasury and Federal Reserve policies came early in 1951. Commenting on the impasse in its report for 1951, the Board said that it had become increasingly clear that anti-inflationary credit and monetary measures could not be made effective—in fact, that credit and monetary developments would be inflationary—as long as Government securities were given a "money quality" by support of their price. Market support was not immediately withdrawn after the accord. Limited purchases of long terms were made on a scaledown of prices, and, pending refunding of short terms,

it was agreed to stop open-market buying and let the rate gravitate around the market rate.

During 1952, the Federal Reserve objective was to encourage an increased volume of current saving to meet the credit demand and to restrict bank credit and monetary expansion to meet the growth needs of the economy. The pace of credit expansion was restrained by making it necessary for banks to borrow in order to get reserves. Thus, rediscount operations again became an effective instrument.

In the annual report for 1953, the Board defined its concept of a free, more self-reliant financial market as one in which the allocation of available funds among various uses is effected through competition in the market. In such a market, open market operations would be solely to influence the volume of bank reserves to promote economic stability and growth, and the Federal Reserve would seek to make its action as broad, general, and impersonal as possible. It would neither establish prices for particular classes of securities directly, nor set up or maintain particular relationships in rate levels such as might impair the efficiency of the market in its allocative function.

This is an excellent description of a free-money market and the central bank's relation to it. The principal obstacle to attainment of the standard set forth in the foregoing paraphrase of that description is likely to be the exigencies of Federal financing and debt management.

To minimize the impact of open-market operations, the following changes were made in 1953:

(1) Short-terms were emphasized

(2) Operations were limited to provision or absorption of reserves, except in correction of a disorderly market

(3) Operating techniques were changed during refundings, by discontinuance of buying "rights," "when issued" securities, and comparable outstanding securities.

The manner in which the Board's directives to the Open Market Committee were adjusted to the changing economic situation during 1953 is shown by the following:

> March 1953: Transactions to be with a view to "exercising restraint upon inflationary developments."
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> June 1953: Transactions "to avoid deflationary tendencies without encouraging a renewal of inflationary developments."
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It would appear from this outline of the shift from inflation restraint to active ease the Board was correctly interpreting the signs which were pointing to the recession of 1954. There has been criticism that the Board was not sufficiently alert in moving from one course to the other, but these have been based on hindsight, and it is doubtful if the critics could have done better when the right policy was still uncharted.

The "condition of ease" policy was followed through most of 1954, by reducing the rediscount rate, lowering reserve requirements, and open-market operations to increase reserves. In the autumn of 1954

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A similar policy of alternation between increased credit restraint and action to increase bank reserves was followed in 1956. For example, in January the System reduced holdings of Government securities by more than $1.4 billion, to offset seasonal return flow of currency and reduction in reserve needs. In February and March small amounts of securities were bought at times to meet changing reserve needs and avoid an increasing degree of credit restraint in view of the growing tone of uncertainty as to economic prospects. In April and May discount rates were advanced and some $350 million of securities were sold because of indications of broad increase in spending and growing demands for credit. Member bank borrowings rose to more than $1 billion, a further indication of the rising demand for credit. From late May to early August, System holdings of securities rose to meet currency needs of the vacation season and to cover added demands for reserves around tax settlement and midyear settlement periods. From August to November discount rates were advanced to 3 percent, in conformity with the rise in market rates. At the same time System holdings of securities increased by nearly $1 billion. Even so, member bank borrowings averaged $900 million in August and between $700 and $800 million in other months. System holdings increased still more in December.

This short summary of Federal Reserve policy and action during 1956 is an application of orthodox theory to the condition of strong economic advance. According to this theory, the credit supply should continue to be adequate for necessary business needs but it should cost more. The Federal Reserve Board contends that the successive increases in the rediscount rate were made to keep that rate abreast of the market rate, which was rising because of the strong demand for credit accommodation. The motive was to impose restraint on the growing inflation while still keeping the money supply adequate to do the necessary money work. The Board is aware, of course, that the available lending capacity of the banks is determined by their reserve position and that the volume of bank reserves, in turn, can be determined by the open-market policy. In recent years the Board has designed the open market operations so as to involve a considerable amount of member bank borrowing, a condition which is necessary if the rediscount rate is to be an effective instrument of credit control.

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A similar policy of alternation between increased credit restraint and action to increase bank reserves was followed in 1956. For example, in January the System reduced holdings of Government securities by more than $1.4 billion, to offset seasonal return flow of currency and reduction in reserve needs. In February and March small amounts of securities were bought at times to meet changing reserve needs and avoid an increasing degree of credit restraint in view of the growing tone of uncertainty as to economic prospects. In April and May discount rates were advanced and some $350 million of securities were sold because of indications of broad increase in spending and growing demands for credit. Member bank borrowings rose to more than $1 billion, a further indication of the rising demand for credit. From late May to early August, System holdings of securities rose to meet currency needs of the vacation season and to cover added demands for reserves around tax settlement and midyear settlement periods. From August to November discount rates were advanced to 3 percent, in conformity with the rise in market rates. At the same time System holdings of securities increased by nearly $1 billion. Even so, member bank borrowings averaged $900 million in August and between $700 and $800 million in other months. System holdings increased still more in December.

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3 percent in November, and to 2¾ percent in January 1958. Reserve requirements were reduced by one-half of 1 percent for all classes of banks in February 1958 and by another one-half of 1 percent in March.

In retrospect, a question might be raised as to the accuracy of the Federal Reserve Board's timing for the transition from restraint to ease. To be effectivve, credit ease must be introduced while there is still a substantial demand for credit to be stimulated. If this demand is already tapering off for other reasons, easier credit terms may be slow in reversing that trend. This question is easier asked than answered, for it would have been difficult in August 1957, in face of the evidences of continued inflation, to be absolutely certain that prolonged recession was about to begin.

Question 4. Beginning in August 1956 there was an increase in the Consumer Price Index each month through September 1957 thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

Answer. In terms of the 1947–49 base, the index of all consumer prices was 116.8 in August 1956 and 121.1 in September 1957. This was a decline in the purchasing power of the dollar from 85.6 cents in August 1956, to 82.5 cents in September 1957.

It should be noted that the shift of the index to the 1947–49 base instead of the old 1939 base conceals the earlier serious loss in dollar purchasing power which took place during and after World War II and deprived it of nearly half of the purchasing power it had in 1939. On the 1939 base, the purchasing power of the dollar in November 1957 was 48.5 cents.

The 13 months from August 1956 through September 1957 is a rather limited period, with a restricted price range, within which to pinpoint causal influences. However, we know that during this period the Federal budget was approximately balanced and the money and credit situation was restrained. The postwar gap between production and money supply had finally closed. Consequently the full force of continuous wage increases came to the forefront of the inflationary scene. Wage increases in excess of productivity gains during this period became the new force for inflation, and drove prices upward.

The index measures the effect of price changes on the cost of goods and services in the family market basket. The quantities and qualities of goods and services are assumed to remain the same, and the changes in cost are the result of price changes. Some 300 items are included in the index, more than half of which are food and apparel items. The relative importance of the different categories is determined by a weighting system based on the spending habits of the consumer groups for which the index is primarily designed, namely, city wage-earner and clerical-worker families. The largest weights are assigned to food (28.7 percent), shelter, other than rent (12.4 percent), transportation (11.2 percent), and apparel (9 percent). The prices of the individual items in the market basket are continually moving up or down in response to the changing balance of demand and cost influences. The overall index is a composite of these separate price movements. It would have been higher by September 1957 than it was except for the relatively small advance of the indexes for food (3.9 percentage points), apparel (1.8 percentage

points), and rent (2.5 percentage points). On the other hand, transportation cost rose by 7.4 points, medical care by 5.7 points, reading and recreation by 5.4 points, and services other than rent by 6 points. Except for the low weighting assigned to all of these categories, other than transportation, the overall index would have been still higher in September 1957 than it actually was in that month.

Demand

An indication of the relative strength of demand for particular classes of goods or services during the period in question is provided by the changes of the indexes for the major components of the market basket as shown above. However, the prices of individual items are also affected by such matters as cost, shortage or excess of supply, shifting preference of consumers, and so on.

The vigor of demand is determined by the available means of payment plus a willingness to spend. There was a strong increase of consumer spending during the period under review.

In the third quarter of 1956, which includes the month of August, the total consumer spending was at an annual rate of $268.6 billion. In the third quarter of 1957, which includes the month of September, the annual rate was $283.6 billion.

Thus the annual rate increased by $15 billion over a year which included the terminal months of the period in question. Personal income rose from an annual rate of $328.1 billion in August 1956 to an annual rate of $347.2 billion in September 1957. Labor income, which is by far the largest component of personal income, advanced from an annual rate of $234.4 billion in August 1956 to an annual rate of $249.5 billion in September 1957.

The increase of labor income represents an increase of production costs as well as an increase in demand potential. The following changes occurred in average hourly earnings and average weekly earnings during the period in question.

Dates	All manufacturing	Manufacturing durable goods	Nondurable goods	Building construction	Retail trade
(a) Average hourly earnings:					
August 1956	$1.98	$2.10	$1.81	$2.81	$1.58
September 1957	2.07	2.21	1.88	2.97	1.67
(b) Average weekly earnings:					
August 1956	79.79	85.68	71.68	104.53	61.78
September 1957	82.99	89.24	75.24	111.14	64.01

Supply

The supply side can be indicated by the index of industrial production. The overall index moved only from 143 in August 1956, to 144 in September 1957. Total manufactures went up from 144 to 146; the durable goods index went from 158 to 159, and the nondurable index from 130 to 132. This included a relatively sharp increase of chemicals and petroleum products from 167 to 174. The index of output of consumer durables moved from 127 to 129. The index of foods, beverages, and tobacco was unchanged at 113.

These meager data suffice to reveal that in the overall, total production did not increase significantly during the period in question.

When the drift of a whole series of price indexes is in one direction, in this case upward, attention should be given to the money side of the price equation.

The money supply

As of August 1956, demand deposits excluding interbank and United States Government deposits, were $106.1 billion, and currency outside banks was $27.5 billion. In September 1957 the corresponding figures were bank deposits $106.2 billion and currency $27.7 billion. The net increase from beginning to end of the period in question was $300 million. There were minor variations in the monthly totals, the maximum being $108 billion of deposits and $28 billion of currency in July 1957. It will be recalled that the Federal Reserve Board raised the rediscount rate to 3½ percent in August 1957. Bank deposits fell by $1.8 billion from April to the end of September 1957. However, they rose again by $3.4 billion at the end of December.

Total purchasing power is made up of the money supply and the velocity of circulation or turnover. Velocity is measurable only for part of the bank deposits. The Federal Reserve Board compiles data on velocity for New York City, 6 large centers, and 337 other centers. The figures at the beginning and the end of the period in question were:

Date	Velocity or turnover of demand bank deposits		
	New York City	6 other centers	337 other centers
August 1956	51.3	29.9	22.7
September 1957	50.9	31.7	23.7

In all three of these series on velocity, there were monthly variations up and down from August 1956 level. The series for New York City includes a large volume of financial transactions and this is true, though in lesser degree, of the series of six other large centers. The general trend across the country is best indicated by the velocity rate in the 337 other centers. The net change of 1 point in this rate was an increase of some 4.4 percent in the rate at which the demand deposits included in the survey were turned over during the period.

Consumer credit outstanding rose from $39,898 million in August 1956 to $43,270 million in September 1957 a total increase of $3,392 million or a monthly average of $261 million. The actual monthly increase was quite irregular, however, ranging from $587 million in December 1956 to a decrease, or net repayment, of $80 million in February 1957. Nevertheless there was a net increase of some $3.4 billion which represented strong demand and contributed to the total of consumer spending.

Summary

The evidence briefly reviewed in the above discussion may be summarized thus:

First, there was no material increase in the rate of production of goods.

Second, there was a strong and rising demand, as indicated by the increase of consumer spending.

Third, there was a marked rise in personal incomes, and particularly in labor incomes. This rise made the total effective demand possible, but the reverse of the coin is that the increase of labor incomes also meant an increase in production costs.

Fourth, the net increase of spending by way of consumer credit purchases added to the pressure of total demand on the available supply of goods.

Fifth, an increase of 4.4 percent in the velocity of bank deposit circulation was equivalent to some increase in the money supply, but the bank debits in the 337 centers, where this increase occurred, were only about 40 percent of total debits to demand deposit accounts in 1957. An increase of velocity is a response by business and individuals to a rising cost level when there is restraint on increase of the money supply. But the steady rise of the Consumer Price Index was interpreted to mean that restraint was needed. Thus, the Federal Reserve Board's dilemma was either to validate the increased costs resulting from rising wages or run the risk of deflation becoming recession by restricting the money supply.

Question 5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

Answer. Management of the public debt involves the following:

1. Retirement of debt when and as a surplus of revenues permits;
2. Refunding of maturing issues insofar as they cannot be retired;
3. Selection of the particular issues to be retired when redemption is possible, and determination of the terms of refunding—types of new issues such as bills, certificates, notes or bonds; maturities; interest rates; and special features such as provision of a call date prior to maturity, eligibility for bank investment, and others.

Major problem of debt management

The principal problem of public debt management, in its relation to the national credit structure, is to handle the successive refundings in such a way as to minimize the competition between the Treasury and the private economy for the limited supply of funds available for investment in debt paper. The supply of such funds in the hands of nonbank investors is unduly and improperly restricted by the excessive rates of income tax which now absorb so much of the private income that would otherwise be saved and invested. The lack of private saving capacity and attitude has resulted in greater use of the banks in public debt financing and management, a policy which has been a factor in the credit inflation that has plagued the country since World War II.

The Treasury's dilemma may be stated thus: From the standpoint of sound debt policy, it is desirable to fund a substantial part of the debt into long-term maturities, first, in order to reduce the risks involved if a new emergency should compel sudden, extensive refinancing of short-term and demand debt in addition to raising new money; and second, to avoid the well-nigh continuous impact on the money market of successive refinancings of short-term maturities. But a sustained, vigorous Treasury campaign to refund maturing issues into long-term maturities would tend to deplete the supply of long-

term investment funds to the detriment of business and mortgage financing. In the case of business, the income tax has been primarily responsible for the preponderance of debt in business financing since 1945. For example, the increase of corporation debt from 1945 through 1956 has averaged $11 billion a year, as against $2 billion a year in new capital stock issues.

With respect to the mortgage financing underwritten in any way by the Federal Government, there is evidence that the restrictive provisions which are a condition of Federal participation or support have often hindered a free flow of funds into such investments.

Short-term debt

It has often been urged by some that an ample supply of short-term Federal debt is necessary to provide the banking system with a liquid secondary reserve against their deposits. In this connection "liquidity" means sale for or convertibility into cash quickly and without loss. In this theory, the Treasury bill is the most liquid form of public debt paper. But this is true only for one holder or a small number of holders. If all of the banks were to present all of their holdings of Treasury bills for redemption at one time, the Federal Reserve banks would be obliged to provide the Treasury with a credit sufficient to redeem the bills.

As a matter of fact, the present volume of securities maturing within 1 year is far greater than would be needed for secondary bank reserves. As of February 1958, the total public debt paper maturing within 1 year was $82.7 billion, while the total of demand deposits, excluding interbank and United States Government deposits, was about $106 billion.

Legislative changes

The test of good debt management mentioned above, namely, to minimize the competition between the Treasury and the private economy for the available funds, will be more easily met by introducing changes in the tax laws whereby the supply of funds for long-term investment would be increased.

Another policy which would enhance the favorable attitude of investors toward long-term Federal securities would be firm assurance that the Federal spending would be controlled and reduced, to avoid, in future, the inflationary deficits that undermine the value of long-term investments.

Given these conditions, the Treasury could safely and successfully pursue a policy of gradual transfer of a larger proportion of the debt into long-term paper. The policies indicated above would materially contribute, also, to the stability of the national credit structure.

Question 6. (*a*) Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy in the United States:

1. Price stability.
2. Stability of production, demand and employment.
3. Economic growth in production demand and employment.

Answer. Rightly understood, the three objectives blend together and strengthen each other. They cannot be properly and adequately discussed as separate and mutually exclusive concepts. The ultimate national need is, of course, economic growth. This growth will be

most beneficial for all segments of the economy if it can proceed at a steady pace, without the distortions produced by the extremes of boom and recession or depression. The most equitable distribution of the fruits of economic growth among all of the people is likely to be achieved if the general price level can be held on a fairly even keel, that is, without the excesses of either a marked rise or fall of prices.

Such an objective as to price stability, if it could be achieved and held, would promote stability of production, demand, and employment. That is, it would be as effective protection against boom and depression as would be possible through the operation of monetary controls. It has long been recognized that a good way to keep out of a recession is to avoid the preceding inflation.

The national objectives stated in the question, and any program for their realization are likely to remain a "counsel of perfection" as long as there are retained in the national policy the built-in commitments to inflation which now exist. Examples are the agricultural price supports, the general tolerance of wage increases at a rate faster than the increase in national productivity, Federal credit programs and unreasonable restrictions on general freedom of trade. The pressure on costs which these policies generate must in time be offset by injections of additional money into the economy in order to prevent unemployment, and thus the inflationary thrust is given new impetus.

Question 6. (*b*) With respect to these three objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially in 1957.

Answer. The most important development relating to prices after World War II was the marked inflationary uptrend. As indicated by the Wholesale Price Index (1947–49 base) the general price level rose by nearly 46 percent from 1946 to 1951. It leveled off thereafter to 1956, with a range of only 4.7 percentage points between high and low in this latter period. In 1956, however, there was a definite impetus toward higher prices and this tendency carried over into 1957 but with diminished vigor. On the whole the wholesale price level was well stabilized in 1957, with a range of only 1.5 percentage points between monthly high and low.

Using the Consumer Price Index as the indicator (1947–49 base), the rise from 1946 to 1951 was 33 percent. In contrast to the behavior of the Wholesale Price Index after 1951, however, the Consumer Price Index rose continuously thereafter through to 1957 except for a setback of 0.3 percent points in 1955. The monthly index advanced steadily in 1957 from 118.2 in January to 121.1 in September and October, then to 121.6 in November and December.

Production.—The Index of Industrial Production moved upward after 1946 except for the 3 recession years, 1949, 1954, and 1957. The advance was irregular, being greater in some years than others. The decline through 1957 (10 percentage points) was more than in either 1949 (7 percentage points) or 1954 (9 percentage points).

Demand.—The effect of the 1949 and 1954 recession on demand, as measured by personal consumption expenditures, was to slow down the advance, but in no instance through 1957 was the spending trend reversed. The proportion of consumer spending devoted to services

moved up from 31.5 percent in 1946 to 37.6 percent in 1957. The category of services includes the imputed rental value of owner-occupied houses, and the spread of home ownership has contributed to raising the housing component of the service category from 30.7 percent in 1946 to 32.7 percent in 1957.

Employment.—From 1946 through 1957, on an annual basis, employment kept even with the growth of the civilian labor force. Figures in thousands for the 2 years are:

[In thousands]

Year	Civilian labor force	Employment	Unemployment
1946	57,520	55,250	2,270
1957	67,964	65,272	2,693
Net increase	10,444	10,022	423

Within each year, however, there have been wide variations of both the labor force and the number employed. These monthly changes from high to low for the years 1956 and 1957 are worth noting. They are shown below in thousands:

Month	Civilian labor force	Employment	Unemployment	Net changes		
				Labor force	Employment	Unemployment
January 1956	65,775	62,684	3,092			
July 1956	69,489	66,354	3,134	+3,714	+3,770	+42
January 1957	65,821	62,578	3,244	−3,668	−3,776	+110
July 1957	70,228	67,221	3,007	+4,407	+4,643	−237
January 1958	66,732	62,238	4,494	−3,496	−4,983	+1,487

A peculiarity about these labor force totals for which no explanation appears, is the difference in the movement between high and low in 1956 and 1957. From January 1956 to July 1956, the labor force increased by 3,714,000, and from July 1956 to January 1957 it declined by 3,668,000, leaving the labor force in January 1957 only 46,000 higher than it had been in January 1956. The seasonal increase raised the labor force by 4,407,000 in July 1957, but the drop in the labor force to January 1958 was less than the preceding rise by some 911,000. It is to be expected that the labor force will grow as the population expands. The point here is that the annual increment picked up in the seasonal swings should be fairly uniform. A net gain of 46,000 in 1 year followed by a net gain of 911,000 leaves something unexplained.

Further light is thrown on the employment trend by the age and sex composition of the labor force. The figures for 1946 and 1957 are given herewith:

Year	Employed					Unemployed				
	14–19	20–44		45 and over		14–19	20–44		45 and over	
		Male	Female	Male	Female		Male	Female	Male	Female
1946	4,550	21,170	9,870	15,280	4,380	290	1,200	280	410	90
1957	4,720	23,993	11,247	17,246	7,804	574	935	566	606	255
Net change	+170	+2,263	+1,377	+1,966	+3,424	+284	−265	+286	+196	+165

As the years pass the members of the labor force move from one age group to another. The most striking disclosure of these figures is the relative increase of females aged 45 and older in the labor force. And except for the male age group 20 to 44, which had a net decline in unemployment from 1946, to 1957, fewer females aged 45 and older lost their jobs over this period than any other category.

Economic growth.—The gross national product has more than doubled since 1946, the figures being, in current dollars, $209.2 billion in 1946 and $433.9 billion in 1957. This growth represents an annual rate, compounded, of 6.9 percent. But the current dollar figures are materially distorted by inflation, and hence they suggest a greater addition to the national economic strength and well-being than is actually the case. In terms of constant 1947 dollars, gross national product has risen from $232.2 billion in 1946 to $334.7 billion in 1957, which is a growth rate, compounded, of 3.3 percent. When stripped of the influence of inflation the rate of growth since 1946 was not equal to the historic rate since 1869, which, down to 1928, was some 3.8 percent, compounded annually.

The year 1957 does not make a good showing in these comparisons. The increase of gross national product in that year over 1946 was almost 5 percent, but 4 percentage points were a result of inflation and only 1 percentage point constituted increase in physical terms.[1]

Question 7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

Answer. Government spending for goods and services—Federal, State, and local—is a component of gross national product as a matter of statistical compilation, but this means that Government absorbs certain dollar amounts in the annual total. The issue presented by the question is whether such spending, in one amount rather than another, is beneficial or harmful for the economy.

[1] Economic Report of the President, January 1958, p. 53.

The first point in this connection is that the Government spending does not correlate at all times with the movement of gross national product. The relationship for certain years is given herewith:

[In billions]

Year	GNP	Government spending	Year	GNP	Government spending
1929	$104.4	$8.5	1948	$257.3	$36.6
1931	76.3	9.2	1953	363.2	84.4
1940	100.6	14.1	1955	391.7	77.4
1944	211.4	96.5	1957	433.9	86.6

These figures show that the amount of Government spending is not always a positive factor in determining gross national product. When that product is rising, an increase of Government spending swells the dollar amount of the product; but in two instances, 1944–48, and 1953–55, gross national product continued to rise although Government spending was reduced. And from 1929 to 1931, gross national product fell although Government spending was increased.

The conclusion is that there are more powerful forces than Government spending which determine the changes in gross national product unless, as in World War II, the spending is on a scale so large as to dominate the economy. When these forces are unimpeded, a decline in Government spending will not hinder or prevent continued increase of gross national product. On the other hand, it is more likely that a reduction of Government spending, with a basic reform of the income-tax-rate structure, would contribute materially to the release of the growth forces on which the national economic advance depends.

A second point involves the assumption so frequently made that Government spending always contributes to the general welfare. This assumption is sharply contradicted by the record from 1944 to 1948, when gross national product increased by $46 billion notwithstanding a reduction by Government spending by $60 billion. Yet this assumption continues to be made, and it is currently (March 1958) being used to support legislative proposals for increased Government spending as a cure for the recession. The following passage from the Economic Report of the President, January 1958, should be considered by believers in this assumption (p. 56):

"Because the provision of services by Government requires that income be claimed that would otherwise be used privately, the first of these objectives (i. e., to make adequate provision for public services) means, in a broad sense, that the amount of income which is taken in taxes, the sources from which taxes are drawn, and the way tax receipts are spent, should be such as to maximize Government's contribution to national welfare. Constant vigilance is needed to get the work of Government done at the lowest cost consistent with the desired level of performance * * * but vigilance is needed also *to assure that the income which Government takes in taxes makes a greater contribution to well-being when spent publicly than it would if used privately.*" [Italic supplied.]

Government spending for essential public services, "at the lowest cost consistent with the desired level of performance," unquestionably contributes to the national welfare. The key point in the above pas-

sage is the warning against unlimited public spending which is conveyed in the declaration that there must always be assurance that Government can spend the people's money more wisely and more beneficially than they can.

This test cannot, of course, be made with objective exactness because of the great range of individual bias for or against more Government. It is submitted, however, that the best result will be achieved by insisting that the range of Government activities and the amount of Government spending of tax revenues be materially restricted, rather than by allowing Government a free hand in expanding its operations and unlimited access to the incomes of the people. The reason for this conclusion is that, since well-being depends on economic growth, the growth forces in the economy will operate most vigorously and most efficiently when they are impeded in the least degree possible by the burdensome exactness and controls of Government. Excessive and discriminatory taxation, which involve an arbitrary assumption that Government can spend private income to better advantage than private persons can, is a most serious impediment to growth.

Government spending in excess of revenues necessarily involves borrowing. State governments are prevented by their respective constitutions from incurring debt without popular approval. State legislation usually limits and controls local borrowing. The principal market for State and local debt paper is provided by individual and institutional investors and comparatively little of it is sold to commercial banks in the first instance. Hence there is a minimum of inflationary effect from State and local borrowing.

On the other hand, large-scale Federal borrowing tends to be inflationary because a substantial part of any large Federal debt issue in the past has ordinarily been taken by the banks, and the same procedure would no doubt be followed again. Thus there would be introduced once more a strong inflationary trend, with its resultant inequities and further loss of value of the dollar.

Deficit spending and credit inflation cannot restore lasting vigor to retarded growth forces. The most certain way of reinvigorating the economy is by adopting a sensible program of tax rate reform with forward scheduling of rate reductions. Under such a program, resumed economic growth would expand the tax base more than enough to offset the revenue effect of scheduled tax rate reductions. In the circumstances now existing (March 1958) the initial effect might be a deficit, although this is by no means certain unless the spending is allowed to get entirely out of hand. Even so, a deficit resulting as the first impact of tax reduction along the lines proposed above is self-correcting, because of the dynamic effect of the tax cut on economic growth. In contrast, deficits deliberately incurred in the hope of stimulating the economy tend to become self-perpetuating and hence, self-defeating.

Question 8. Give your opinion as to the effect on our economy of current Federal, State, and local taxation.

Answer. The latest available data for 1956, indicate that the total load of Federal, State, and local taxation was then $121.2 billion. This exceeded one-third of the national income, which was $343.6 billion in 1956 and $358.5 billion in 1957. While no precise ratio of tax burden to national income can be proved to be the breaking point, a load in

excess of one-third should be viewed with deep concern, for it is possible that, without our realizing it, this point has already been reached. In fact, considering that the current recession is in large degree characterized by psychological reactions, the issue becomes even more germane. Pessimism takes over from optimism in the business world when the prospect of inadequate profit, or of no profit at all, looms too prominently on the business horizon. Excessive taxation means that the worker, the entrepreneur, and the investor, are not allowed to keep enough of the income earned to maintain the incentives to do more and get more.

State and local tax systems differ widely in detail among the States, but they have in common certain general characteristics. They consist mainly of property taxes, sales taxes, business and individual income taxes, inheritance and gift taxes, and selected excises on beverages, tobacco, gasoline, and motor vehicles. The relative proportion of total revenues derived from the several major sources of revenue varies greatly, but in each State the particular local arrangement appears to have the approval of the citizens. Improvements could no doubt be made here and there, and, as experience has shown, such action has been and will be taken when the local demand for it becomes strong enough. The Commission on Intergovernmental Relations suggested that the States could be more alert to discover and utilize more revenue sources within their own borders, but no specific examples were offered. Any necessary or desirable reforms of State and local taxation are matters of local concern, beyond the purview or authority of Federal agencies.

On the contrary, the Federal revenue system is very much a responsibility of the Congress and the executive branch. Being nationwide in scope, the bad features of the Federal tax system blanket the whole country and hence they are magnified accordingly.

The most damaging part of the Federal tax system is the excessive rates of the income taxes. In the budget for fiscal year 1959 these taxes are estimated to produce $58.9 billion, or 79.1 percent of net budget receipts. This extreme proportion is a result of the rate structure which has built up over the years and which has been retained virtually intact in peace as in war. It is appropriate to levy heavy taxes during war emergencies, which require intense effort from all through the periods of active hostilities. But the restrictions of wartime cannot and should not be retained beyond the war period. This has been recognized in the removal of rationing and other controls over the people, and also in the repeal of excess profits taxes. It has not been recognized in the case of the income tax rates, which still stand as a monument to the oppressive burdens of the war period.

If the economy is allowed to realize its possibilities of maximum growth, there would be no case for excessive tax rates in order to support the necessary public expenditures. The growth that would be promoted under a moderate tax rate structure would lighten the tax burden on individuals and businesses even if this could not be done by a substantial reduction of Government spending.

No justification can be found either for retention of excessive income tax rates on the ground that we are in a cold war. This kind of war can go on for a generation or more, and the fundamental requisite for victory in it is the development of a strong, growing economy. The major handicap to growth is the income tax rate structure.

It is no answer to reply that the country has grown under the present tax rates. When the effects of inflation are removed it is found that our growth since 1946, as indicated by gross national product, has been only about 3.3 percent compounded annually. In view of the rate at which the Soviet Union is growing, we may well lose the race for economic supremacy unless we can do much better than 3.3 percent. And when the economic race is lost there is little chance of victory in a military contest.

The principal counts in the indictment that can be brought against excessive rates of income taxation are:

1. They are a serious impediment to economic growth, because:
   (*a*) They lessen the incentives to produce;
   (*b*) They impair the capacity to save and the willingness to save and invest, thereby slowing up the rate of capital formation, which is the indispensable economic condition for growth;
   (*c*) They distort business decisions by compelling undue attention to the tax consequences of these decisions;
   (*d*) They divert the time and energy of business executives from management problems to tax problems;
   (*e*) They impair taxpayer morale.
2. Excessive rates of income tax negate the operation of the free market as the ultimate determinator of rewards for economic effort. The more industrious, energetic, and capable the individual, the greater the tax penalty.
3. They promote centralization of governmental functions at the Federal level by affording a monopoly of taxable resources, which leads to the vicious circle of Federal fiscal supremacy and State dependency.
4. The pessimism which excessive tax rates normally engenders is accentuated under recession conditions. In any close balancing of business and economic factors, the impact of excessive tax rates may well be a deciding factor in the direction of an economic downturn.

A dangerous consequence of the steep progressive rates of Federal estate tax should be noted. It is common knowledge that many large estates have been put into tax exempt trusts or foundations in order to avoid this tax. Insofar as trusteeship may, now or later, involve an influence on the management of the properties of businesses represented by the securities placed in trust, it will be in the direction of cautious, conservative polices. The danger is that dynamic, imaginative, courageous leadership of industry may be stifled by the caution and conservatism that are normal attributes of trusteeship. The law of mortmain has long since been abolished, but here is the possibility of a new kind of "dead hand" control that could be fatal to economic advance.

NAM has long advocated return of the estate and gift taxes to the States. Were this done, it is less likely that the trend toward lodging estates in foundations would be as strong as it now is, because the rates of transfer tax would be lower at the State level. The vitality of American enterprise requires that the control of enterprise be with the living, not with the dead.

Question 9. Will you distinguish between fiscal policy (embracing expenditures, taxes, and debt) and monetary and credit policy, and then relate, them, one to the other. Please discuss these policies stat-

excess of one-third should be viewed with deep concern, for it is possible that, without our realizing it, this point has already been reached. In fact, considering that the current recession is in large degree characterized by psychological reactions, the issue becomes even more germane. Pessimism takes over from optimism in the business world when the prospect of inadequate profit, or of no profit at all, looms too prominently on the business horizon. Excessive taxation means that the worker, the entrepreneur, and the investor, are not allowed to keep enough of the income earned to maintain the incentives to do more and get more.

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On the contrary, the Federal revenue system is very much a responsibility of the Congress and the executive branch. Being nationwide in scope, the bad features of the Federal tax system blanket the whole country and hence they are magnified accordingly.

The most damaging part of the Federal tax system is the excessive rates of the income taxes. In the budget for fiscal year 1959 these taxes are estimated to produce $58.9 billion, or 79.1 percent of net budget receipts. This extreme proportion is a result of the rate structure which has built up over the years and which has been retained virtually intact in peace as in war. It is appropriate to levy heavy taxes during war emergencies, which require intense effort from all through the periods of active hostilities. But the restrictions of wartime cannot and should not be retained beyond the war period. This has been recognized in the removal of rationing and other controls over the people, and also in the repeal of excess profits taxes. It has not been recognized in the case of the income tax rates, which still stand as a monument to the oppressive burdens of the war period.

If the economy is allowed to realize its possibilities of maximum growth, there would be no case for excessive tax rates in order to support the necessary public expenditures. The growth that would be promoted under a moderate tax rate structure would lighten the tax burden on individuals and businesses even if this could not be done by a substantial reduction of Government spending.

No justification can be found either for retention of excessive income tax rates on the ground that we are in a cold war. This kind of war can go on for a generation or more, and the fundamental requisite for victory in it is the development of a strong, growing economy. The major handicap to growth is the income tax rate structure.

It is no answer to reply that the country has grown under the present tax rates. When the effects of inflation are removed it is found that our growth since 1946, as indicated by gross national product, has been only about 3.3 percent compounded annually. In view of the rate at which the Soviet Union is growing, we may well lose the race for economic supremacy unless we can do much better than 3.3 percent. And when the economic race is lost there is little chance of victory in a military contest.

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Question 9. Will you distinguish between fiscal policy (embracing expenditures, taxes, and debt) and monetary and credit policy, and then relate, them, one to the other. Please discuss these policies stat-

ing how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

Answer. The distinction is already indicated by the parenthetical insert. Fiscal policy includes the measures taken to provide public revenues, to pay the expenses of the Government, and to supplement, where necessary, the current tax and other revenues by borrowing additional funds. Monetary and credit policy includes operation and management of the banking system in providing the necessary money supply through bank loans and investments, and the overall regulation of this supply by the Federal Reserve Board.

There are various links between the two policies and the agencies whereby they are implemented. The Federal Reserve banks act as fiscal agents of the Government. They cooperate closely with the Treasury in the management of the public debt. The banks serve as depositaries of funds obtained through taxation or borrowing until these are drawn upon for Government use. The Federal Reserve Bank of New York acts as the Treasury's representative in foreign transactions. An important link is the service rendered by the banks when deficits must be financed by the issue of new debt paper. At this point fiscal policy reaches over into monetary and credit policy in order to secure the additional funds needed to cover the public spending.

But the two policies serve different ends and should not be regarded as interchangeable, nor as substitutes one for the other. Under a sound fiscal policy Government spending would be sufficiently controlled and restricted to avoid imposition of a crushing tax burden; the tax system would be so organized as to provide the necessary public revenues without the levy of excessive or discriminatory taxes; and by keeping the budget balanced, resort to inflationary deficit financing would be unnecessary.

The management of monetary and credit policy would make its contribution to the overall goal by providing, through the banking system, enough money to do the necessary money work and by preventing the money supply from becoming so abundant as to impair its value.

The two policies may, on occasion, operate at cross purposes. For example, it is conceivable that at a time when sound monetary and credit policy indicated restraint on the creation of more new money through credit expansion, the budget would be unbalanced and thus render deficit financing necessary, thereby increasing the volume of credit. Or, in a period when credit restriction was necessary, Government loan programs could be setting easier interest and other terms for Government lending.

In order to "restrain inflationary trends and otherwise aid in preserving a stable economy," the best results will be obtained when the two policies keep to their respective grooves. It is often said that fiscal policies can curb a boom by maintaining high tax rates and accumulating a budget surplus. This, it is believed, will reduce the total money purchasing power in the economy and thereby prevent further rise of prices.

If the surplus is held in the Treasury as idle cash, there will be a reduction of the money supply to that extent. For various reasons, however, it is unlikely that the Treasury's cash balance would be al-

lowed to accumulate and remain at a high level. It is far more likely that the surplus would be put to use, and if this is done there is a possibility that the money will be returned to the spending stream. Such, obviously, would be the case if Government spending were maintained at a high level. The most popular use of a surplus is to redeem some of the public debt.

If the debt paper selected for redemption is held by nonbank investors, the result is a transfer of funds from taxpayers to bondholders. Total spending power in the economy is not reduced, and the heavy taxation levied to curb the boom will have been in vain. If the debt to be redeemed is held by the commercial banks, the net effect would be to improve the overall reserve position of these banks. That is, there would be a net decline of privately owned demand deposits in the amount of the taxes paid, and the Treasury checks to the banks in exchange for securities would be cleared into the member bank reserve accounts, thereby increasing the ratio of reserves to deposits. But the member banks would then be in position to increase their loans and they would be inclined to do so where possible in order to replace the earning asset lost through the redemption. Since loan demand is likely to be active in a boom period, there would tend to be an increase of bank credit to offset the previous decline of taxpayer deposits and so, again, there would be no decrease of purchasing power in the economy as a result of the high tax rates. Fiscal policy alone would be ineffective. It could only be made effective if the Federal Reserve Board were to mop up the excess reserves created through debt redemption by selling in the open market, or by changing reserve requirements.

Finally, if the debt redeemed were that held by the Federal Reserve banks, there would be a reduction of the overall money supply but, as in the case of the commercial banks, the Reserve banks would have larger balances and they could transfer funds back into the economy by open market purchases. Such action would be unlikely for it would be counter to the kind of monetary and credit restraint policy that would be proper under boom conditions.

These details are spelled out to show that the reliance on fiscal policy to curb a boom by levying high taxes and redeeming debt will be ineffective unless great care and judgment are used in the application of the budget surplus. And even so, it would be necessary to rely, under some circumstances, on monetary and credit policy to make the effort at control through fiscal policy fully effective. The fact is that the restraint in a boom period that is sought by advocates of fiscal policy can be imposed more effectively through monetary policy.

The general viewpoint with regard to fiscal policy intended to be expressed in this reply is that it should not be thought of, or used, as a means of controlling the economy. The proper use and function of taxation is to provide revenues to pay the cost of the necessary public services. The manipulation of either taxing or spending for the purpose of regulating or controlling or directing the economy will certainly involve trouble for everyone sooner or later. Taxing in excess of the cost of necessary public services involves a presumption that Government can use the additional income to better advantage than the people can, but this presumption is far easier to assert than to prove. There are times when it would be proper to retire some of

the debt, but this proper purpose should not be confused with the levy of excessive taxation at any time as a means of influencing the course of economic affairs. There are other times when it may be necessary to increase the debt because of a gap between the cost of necessary services and available revenues. In such cases the debt increase should be held to the minimum required by a prudent budget situation. A Pandora's box of financial woes is opened whenever deficits are deliberately enlarged by spending projects and new debt is irresponsibly created under recession conditions.

It should be noted that in the doctrine of compensatory budget balance the real purpose of debt reduction out of the surpluses of prosperous periods is not to eliminate debt principal and interest cost once for all, but to clear the way for another large increase of debt in the next depression.

Insofar as the variations from stability in the economy are caused by money and credit factors, or are susceptible of being influenced by these factors, the best means of restraint or stimulus are to be found in monetary and credit policy. The characteristics of an "inflationary trend" are expanding bank credit and money supply, and rising prices. The diffusion of cost increases throughout the economy, whether caused by higher labor costs, material shortages, or other influences, means an increase of prices which tends to reinforce the demand for a larger money supply. Applying the brakes on money supply through Federal Reserve policies is essentially a mechanism for limiting the amount of credit which the banks can extend to their customers, and increasing the cost of such accommodation. The built-in commitments to inflation referred to in the answer to part (*a*) of question 6 are not affected by this kind of credit restriction and the squeeze comes first on the producers who are unable to finance their higher costs under the credit restrictions.

This is not to say that credit restriction should not be utilized in a boom period. On the contrary it should, and the responsible authorities of the Federal Reserve System should be free to handle this problem according to the best information and judgment that can be marshaled for the task. The point to be made here is that while the Nation continues to tolerate other policies which are, in effect, an irresistible force for inflation, the result of credit restriction will be a serious impact on producers. Credit restriction means a refusal to underwrite the forces making for inflation. The blame for the recession which is likely to follow does not lie with this refusal, but with the policies which contributed to make it ineffective as to prices and damaging to the productive forces.

Question 10. (*a*) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purpose of this question consider that the monetary system includes bank deposits and bank credits). Also please furnish your ideas for the correction of any inadequacies that you feel now exist in our monetary system.

Answer. The term "adequacy" is interpreted here to mean the capacity of the monetary system to provide the economy with a money supply sufficient to do the necessary money work, with controls competent to prevent an excessive money supply from impairing its value.

From the standpoint of this definition, it is believed that the Nation's monetary system can be considered adequate. As the national

economy grows, it is evident that a larger money supply will be needed to do the necessary money work at a stable price level. While some overall increase of money purchasing power would be provided by an increase in velocity, this is not the best way of adjustment. High velocity rates, and especially a sudden advance in these rates, tend to breed an atmosphere of uncertainty and distrust in the money and may lead to a flight from the currency which is characteristic to periods of serious inflation. The proper way to assure an increase of the money supply in step with the growing needs of the economy is for the banking system to expand in its capacity to make the loans and investments whereby the overall money supply, including of course bank deposits, would be increased. A larger economy will will naturally need more cash for pocket and till purposes, but this can readily be provided by the issue of more coins and Federal Reserve notes. The member banks would obtain additional notes or coins by drawing them as a charge against their reserves.

The crux of the problem of adequacy is, therefore, the question of the expansion of the resources of the banking system. The ramification of this question, if properly dealt with, would carry the discussion far beyond the tolerable limits of a presentation of this sort. Two major aspects of the problem will be briefly indicated. These are (*a*) the increase of bank capital, and (*b*) the function of bank reserves.

It is obvious that the capital invested in the banking business must increase as the demands on it expand. Capital investment of any sort involves saving, and here again, the evil effect of excessive income tax rates in reducing the capacity and the incentive to save and invest is to be noted. There is no ideal ratio of bank capital to note and deposit liabilities which can be set up as a target, and the actual ratio has declined greatly over the past century. For example, in 1840 the ratio of total capital accounts (including surplus, undivided profits and reserve accounts) to notes and deposits was 157.7 percent. In 1950 it was 8.3 percent.[2] While the soundness of the American banking system has not been impaired by this decline, nevertheless, it does not follow that the matter of capital as a factor in bank strength is unimportant.

Capital investment in banking can be increased either by organizing more banks or by new investment in existing banks. Both methods will no doubt be used. The great expansion of new urban communities and of suburbs around existing cities will require additional, convenient banking facilities. To some extent this need can be supplied by branch banks, although the State laws on this subject are quite diverse.

The original concept of a bank reserve was to serve as limitation on bank liability. No bank is expected or required to keep on hand cash equal to total deposits. Since vault cash or a reserve account with a Federal Reserve bank earns nothing, the inclination of bank management is naturally to keep such assets as low as possible. On the contrary, there is every reason to provide the necessary protection to depositors by investing in income-producing assets of high liquidity. As noted in the answer to question 5, an argument for the

[2] Cf. C. R. Whittlesey, Principles and Practice of Money and Banking, 1954, p. 139.

maintenance of a considerable supply of short-term public debt is that this paper is highly liquid and it is therefore ideal as a secondary bank reserve.

In banking circles today the function of bank reserves is recognized as being essentially part of the technique of credit control, and to provide depositor protection by the maintenance of liquid secondary reserves. If this view of the function of the cash reserve is accepted, the fraction of deposits at which the minimum reserve is set would appear to be relatively unimportant. Recognizing that there is a minimum below which reserve requirements should not be set, central bank control of credit expansion could be as effective at one level as at another, once the credit situation has become adjusted around a given level. For example, the range within which the Federal Reserve Board is authorized to fix reserve requirements is as follows:

Present statutory requirements	Net demand deposits			Time deposits
	Central reserve city banks	Reserve city banks	Country banks	
Minimum	13	10	7	3
Maximum	26	20	14	6

From June 1917 to August 1936 the reserve requirements were at the minimum shown in this tabulation. It is obvious that if the requirements were now at or near that level, the credit control vested in the Federal Reserve Board would be as effective as it would be with the maximum percentages in force. The problem of making available the necessary increase in money supply as the economy grows involves either more and more extensive open market purchases or a reduction in the reserve percentages.

Question 10. (*b*) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

Answer. The word "fiscal" is an adjective from fiscus, which meant the treasury. The connotation developed that this referred to the public revenues, and the term "fiscal system" is often used in this limited connection. In a broader sense, as indicated in the answer to question 9, the fiscal system means the whole array of Treasury functions, which include the gathering of revenue, its spending, and borrowing when necessary. The planning of financial operations, which is now done through the budget, is a fiscal activity that is divided between the executive and legislative branches. That is, the executive prepares the budget and the Congress legislates on its details. These various divisions of the fiscal system can best be discussed separately.

The budget.—The annual budget of the United States Government is, despite its size and detail, somewhat one-sided. That is, it sets forth with great minuteness the spending side of government operations, but it deals only in a sketchy way with the revenues. It is not suggested here that taxing and spending should occupy equal space in the budget, but rather that more complete and precise information be given with respect to the bases for estimates of tax yield and to the reasons for making or opposing specific tax proposals. The case for spending, whether it be for defense, subsidies, public works, or any-

thing else, is carefully developed in the budget message and text, but there is never a comparable exposition and critique of the tax system. No good reason for this reticence exists, since the Congress has the same jurisdiction to initiate spending legislation—which is presented at length—as it does to initiate tax legislation—which is so meagerly considered. It would seem that the legislators would find a discussion of tax policy and practice in the budget as useful and enlightening as is that devoted to spending.

Spending.—Under the Constitution, no money shall be drawn from the Treasury but in consequence of appropriations made by law. The Chief Executive submits to the Congress, through the budget, his spending recommendations but the Congress has the final word on the amount to be spent. In theory, an appropriation is the vehicle for authorizing spending and the appropriation process is the technique of congressional control. But the term "appropriation" has come to have a limited, technical meaning which refers to the specific measures initiated by the Appropriations Committee of the House. In this view it does not refer to other ways of authorizing expenditure, and various devices for bypassing the appropriation process have been developed. Among these are:

(*a*) Authorization to spend from debt receipts;
(*b*) Contract authority created in substantive law;
(*c*) The revolving fund and/or the corporation form of organization; and
(*d*) The trust fund.

In using these alternative procedures there is no violation of the letter of the Constitution, for all of them will have been established and approved by legislative action. It is moot whether or not they violate the intent of the Constitution that all spending shall be in consequence of appropriations made by law. This much appears certain—that there has been serious loss of effective congressional control through their use.

The great size to which the Federal Government has grown, and the increasing complexity of its operations, have militated against the careful supervision of the spending programs which is fundamental to the performance of essential services at minimum cost. In consequence, there is duplication and overlap of agencies and the services they perform, with resulting wasteful expenditure. Bureaucratic empires develop within the Government which exert pressure for a continually expanding scale of operations and spending.

The basic objective, in taking private income and spending it for public purposes should be, in the words of the Council of Economic Advisers, "to get the work of government done at the lowest cost consistent with the desired level of performance" (see answer to question 7.) It is imperative that there be competent, vigorous expenditure control. The law has contained, for years, an effective procedure for this control in the Antideficiency Act (sec. 3679 of the Revised Statutes, as amended). The system of apportionment and allotment provided in this act is capable, under vigorous application, of achieving a prudent use of the funds supplied by Congress. But this procedure must be permitted to operate firmly and impartially. The source of such a policy attitude is the Chief Executive, who is the fountainhead of the will to economize. Where there is vigorous lead-

ership at the top, the pattern will carry down to subordinates. And where there is a sufficient desire, the spirit of economy will extend to regard for taxpayers as well as for the services of Government.

Taxation.—From the standpoint of revenue yield, the Federal tax system must be regarded as adequate. But it is not adequate from the standpoint of being properly designed to serve the best long-range interest of the economy. That interest is the achievement of the maximum growth consistent with stability of prices, production, and employment. In this respect the Federal tax system has the following defects:

1. There is excessive reliance on the income taxes. No other nation depends in as great degree on these taxes as does the United States. The result is instability of receipts and a corresponding insecurity of budget planning.

2. There is an erroneous belief that substantial revenues from the income taxes depend on the maintenance of high rates. Contrary to this belief, the fact is that modern rates will produce a larger revenue over the long run because of the greater rate of economic growth that will result under such rates. Economic growth depends on capital formation and this, in turn, depends on saving and investment. The present high, punitive rates absorb much income that otherwise would be saved and invested, with the result that the Nation's growth rate is much below what it could and should be.

3. Even the income taxes are badly unbalanced as a result of changes in tax payment dates. For example, net budget receipts in the first 6 months of fiscal year 1956 were $25,240 million, and in the second 6 months, they were $42,925 million. This extreme variation was caused almost entirely by the differences in income-tax collection over the year. It involves serious financing problems for the Treasury, shown by the fact that net budget expenditures in the first half of fiscal year 1956 were $33,125 million and in the second half, $33,414 million. In other words, there was a deficit in the first half of $7,885 million, and a surplus in the second half of $9,511 million.

On any standard, this is very bad financial management. It is entirely unworthy of the richest nation in the world, with the highest reputation for managerial competence and "know-how." During the first half of the year the Treasury must go into the market for large sums of new money, thereby adding to the impact of its regular refinancing operations. The Federal Reserve System would have an obligation to ease up on the credit situation sufficiently to accommodate the Treasury, even if, by other tests, the credit situation would require restraint rather than ease.

Question 11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy?

Answer. The situation described in the question appears to fit one aspect of inflation described in the answer to question 1, namely, the case in which a price rise is produced by wage increases. This manifestation of inflation must be confirmed and validated by an increase of the money supply or unemployment will result. See the answer to question 17 for further explanation of this point.

The wage push on prices has been in operation for some time, and both the wholesale and the consumer price indexes have been inching

upward. So far as these indicators show, there is still some inflationary pressure in the economy. But if so, it must be attributable to the wage push, for the money supply has been shrinking. The total of demand deposits and currency at the end of December 1956, was $139.7 billion. After some variations through 1957, this total was $137.7 billion in December, and at the end of January 1958, it was $134.8 billion. The velocity rate in 337 centers reached its high point of 24 in July 1957, and thereafter drifted downward to 22.3 in November. The drop in demand deposits may have resulted in part from the shift into time deposits, which increased from $82.2 billion in December 1956 to $89.7 billion in January 1958.

Something more must be said about the three-cornered relation of money, output and prices than was appropriate in the answer to question 2, and this involves the matter of employment. When forces other than money supply push prices up because these forces have increased costs, then the money supply must be increased or all of the high-priced output cannot be sold. And when such goods cannot be sold, their production is curtailed and fewer workers are needed. In one sense, these goods have been priced out of the market, but it would be equally true that the excessive wage increases have priced some workers out of the market. The expansion of time deposits suggests a growing consumer awareness that some commodities are not worth the prices asked for them in today's money; but the producers must try to get those prices as long as their costs compel them to ask that much if they expect to stay in business.

It would be futile to venture a prediction as to how long high and inflationary prices can continue with no infusion of additional money into the economy. Another way to put it is how much unemployment shall be tolerated at the existing wage level. If we hold fast on money supply and accept another round of wage increases in excess of national productivity, the result would be catastrophic in terms of unemployment. The connection is clear. Higher costs would compel higher prices, but sales would drop further and both output and employment would decline still more.

As noted in the answer to question 15, the alternatives to wage increases at a rate faster than national productivity are either inflation if the money supply is correspondingly increased or unemployment if it is not.

Question 11. (b) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

Answer. By no means. This would be the road to complete destruction of the value of the dollar, loss of the values represented by life insurance, pension funds, annuities, and all investments in fixed income securities such as Government and corporation bonds. It would reduce to destitution the large and growing group of citizens who are now dependent on the protection provided by insurance, pension funds, and other kinds of fixed incomes. It would, in the end, penalize through the inflation the very workers in whose interest this form of national suicide had been introduced.

It should be noted, further, that there is no such attainable thing as a full-employment goal. The continuous employment of 100 percent of the so-called labor force is not realizable. It is not even feasible and the heroic measures that would be required to achieve it would cost

far more than the results would be worth. Among other procedures repugnant to a free society, it would involve an iron discipline over the workers to prevent anyone from taking time off to look for a new or better job; no one would be allowed to resist instantaneous transfer from one job to another or from one section of the country to another; no one would be allowed the privilege of not working for a time if such were his preference.

The Employment Act of 1946 does not mention "full" employment. At most, the goal set by the act is maximum employment, and section 2 of the act merely declares it to be the continuing policy and responsibility of the Federal Government "* * * to use all practicable means consistent with its needs and obligations and other essential considerations of national policy * * * for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment opportunities, for those able, willing, and seeking to work * * *."

The qualifications of this mandate are too often neglected. The practical means to be used in promoting the conditions under which useful employment opportunities are to be provided must be consistent with the Government's needs and obligations and other essential considerations of national policy. This strongly indicates that account should be taken of the public debt, the tax burden and its distribution, and many other relevant matters of national policy. It would certainly rule of a policy of continuous inflation.

Question 12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy?

Answer. The growth of private debt for selected years since 1939 was put into the record of the hearings before the Senate Committee on Finance by Under Secretary of the Treasury Randolph W. Burgess at page 665. The figures, in billions, are as follows:

	1939	1946	1956
Individual debt	$51.0	$60.5	$207.5
Corporation	89.0	110.5	249.0
Total private debt	140.0	171.0	456.5

Some details regarding the composition of individual debt in 1956 were given by Secretary of the Treasury George Humphrey at page 25 of the same hearings. They showed the following:

	Billion
Mortgage	$131.5
Consumer	41.9
Other	34.1
Total individual debt	207.5

A similar distribution of individual debt in 1939 or 1946 is not available. The high levels of mortgage and consumer debt in 1956 would indicate, however, that much of the phenomenal increase since 1946 has been in these two forms.

Both the total individual debt and corporation debt increased, between 1946 and 1956, at a faster rate than national income. The

latter was almost exactly doubled during the decade, but individual debt rose by 166 percent, and corporation debt by 125 percent. Inflation has lessened the burden of debt to individuals and corporate debtors, but at the expense, of course, of the creditors.

A debt is a lien on future income for payment of interest and principal. If the debt is increasing faster than income, it means that the borrowers are reaching farther and farther into the future in hypothecating anticipated income. It is true that the overall total of national income is not the best indicator of the ability of the individual debtors to carry their debt, because it is possible that the incomes of these particular individuals are adequate to support their obligations.

The reverse side of credit is debit, or debt. For every dollar debt, someone somewhere in the national economy—or in the outside world—holds a dollar of credit, an asset against the debtor's liability. We cannot have a credit economy without also having a debt economy.

The question seems to imply, however, that the growth of private debt can in some way be a threat to the economy, but this connotation would hardly have been suggested if the reference had been to the growth of private credit.

In our complex money and credit economy, there is a vast interwoven fabric of debits and credits. Virtually every business has both bills payable and bills receivable, and the same holds for many individuals. Many others may own long-term corporation bonds and at the same time they may owe on a mortgage on a residence or business property. Banks hold promissory notes or bonds against the debt which they owe to depositors as deposit credits.

The Nation's growth has been possible, in very large degree, by the development of this complicated system of debt, with its counterpart of credit. The threat to economic stability in this situation arises when, for some reason, the income anticipations on which debt rests fail to be realized. When one debtor is forced to default, his creditor does not receive the payments on which he has relied to make the payments toward his own bills payable or other debt. However, it would be only when a substantial paralysis of the income flow had occurred that the general economic framework of the Nation would be endangered. Every day there are cases of individual and business failures to meet debt obligations when due, but these small shocks are easily absorbed because of the immense size and resources of the national economy.

This does mean that there can be no danger in an overextension of credit, or its counterpart, debt. It is the responsibility of every person or business firm to make certain—as certain as human judgment can be—regarding the character, capacity, and economic prospects of prospective debtors. The natural law of self-preservation may be relied on here to guard against an abnormal volume of unsound loans, and hence to prevent an accumulation of unsound debt that could become a threat to the economy.

The income-tax law must be held responsible, in part, for the rapid growth of business debt. It does this, first, by allowing interest as a deductible expense in determining net taxable income while not permitting a deduction for dividends; and, second, by hindering the kind of saving and investment that would go into equity, rather than

debt, capital. It will be recalled that during the 1880's and 1890's many large railroad systems went through the wringer of receivership because of their topheavy debt capital structures. The corporation that resorts too heavily to debt rather than equity capital for expansion runs this risk today. This is no doubt fully realized by corporate managements, but the paucity of funds available for equity investment resulting from the excessive income-tax rates leaves them, too often, little choice. And so it can be said, with reason, that the intolerable income-tax rates present a major threat to the stability and vitality of the economy.

Question 13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy?

Answer. This question requests that consideration be given to the financial condition of the United States as a preface to discussion of the steps, if any, to be taken to counteract a downturn. The Employment Act of 1946 contains a similar proviso to the effect that the Government's action to create and maintain conditions favorable to employment opportunities shall be "consistent with its needs and obligations and other essential considerations of national policy."

The Government's financial condition may be summarized as follows:

1. As a result of the maldistribution of tax collections cited in the answer to question 10 (*b*), it has been necessary in recent years to raise the debt ceiling temporarily in order to accommodate necessary financing;

2. It will be impossible to incur any substantial increase of deficit financing without a permanent rise of the debt ceiling;

3. The budget for 1959 is the highest peacetime budget in our history;

4. The country is entering on a new phase of the arms race which, without careful control, will increase the military spending. The burden of defense requires, as the President has said, reduced spending on civilian programs;

5. The taxload imposed by all levels of government on the people exceeds one-third of national income;

6. A review of Federal Reserve Board monetary and credit policies reveals that we have not, since World War II, been entirely free from intermittent inflationary pressures, resulting in part from budget deficits and in part from the built-in commitments to inflation.

Respondents to the question are asked to take into account significant indicators of the Government's financial condition such as those listed above in determining the point at which it should intervene in the recession. Presumably, it would be proper to express a judgment that the financial condition is such as to preclude any intervention. If such an answer were given now it would be academic, because the Government departments are speeding up the use of unobligated balances of appropriations and the congressional bill hopper is full of legislative proposals to deal with the recession. In the sharp focus of concern on corrective measures, too little attention has been given to the solid foundations of the economy. Sales are off but consumers are still spending at an annual rate above that for 1956; production

is down but the rate of industrial production is still some 30 percent above what it was a decade ago; gross private domestic investment is down, largely because of a runoff of some $3 billion in inventory in the last quarter of 1957, which will hasten the time when fresh inventory buying must begin; unemployment is up but more than 60 million persons are still working. Moreover, it seems to have been forgotten that unemployment has not suddenly risen from zero to more than 5 million, but from a normal and probably ineradicable minimum of some 2,500,000 to 5 million plus. For the 9 prosperous years in the period 1947–57 inclusive, unemployment averaged 2,511,000. The particular individuals unemployed were not the same through these years for the average duration of unemployment ranged from 8.1 weeks in 1953 to 14.7 weeks in the second quarter of 1955. Looking for a new job, reluctance to move, unsatisfactory wages or working conditions, and personal prejudice against steady work, were among the causes.

It has been stated that the unions prefer layoff to shorter work time because unemployment benefits would then become payable. And it is well known that the unions would fight for unemployment as against wage reductions. Yet the fact is inescapable that it is better in every way for people to be at work than to be idle and "on the dole." The latter becomes more attractive financially as the unemployment benefit approaches closer to the weekly wage.

The sudden, substantial increase of unemployment which occurred during 1957 is a serious matter for those directly concerned and for the whole economy. A prompt correction of this condition is essential to economic health. In order that effective measures can be devised and applied, however, it is necessary to gain as much understanding as possible with regard to the classes of workers affected. The following tabulations may be helpful to this end.

The table which follows shows the net changes in the labor force and emloyment between January 1957 and February 1958. The figures are in thousands.

Date	Civilian labor force	Employment					Unemployment
		Agricultural	Nonagricultural			Total employment	
			Wage and salary workers	Other nonagricultural	Total nonagricultural		
January 1957	65,821	4,935	52,493	5,150	57,643	62,578	3,244
February 1958	67,160	4,830	51,151	6,007	57,158	61,988	5,173
Net change	+1,339	−105	−1,342	+857	−485	−590	+1,929

The net increase of unemployment between the 2 months, minus the drop in employment, equals the net increase in the labor force. It does not follow, however, that none of the newcomers to the labor force was employed, or that all of them were. The class of nonagricultural workers other than wage and salary workers is a derived figure, being the difference between wage and salary workers and the total of nonagricultural works. It is of interest that this class should have increased by 857,000 in a period when all other classes of workers were losing ground. The composition of the other nonagricultural class is

not known, but it must include proprietors, self-employed, and domestic servants among others.

The heaviest loss in employment during this period was in the wage and salary group. Some details regarding this worker class are given in the table which follows:

Employment of wage and salary workers

[In thousands]

Classification	January 1957	February 1958	Change
Manufacturing:			
Durable goods	10,006	8,850	−1,156
Nondurable goods	7,047	6,787	−260
Mining	832	793	−39
Construction	2,963	2,702	−261
Wholesale and trade	11,465	11,598	+133
All government	7,310	7,516	+206
All other	12,870	12,905	+35

Here we have a picture of the relative incidence of unemployment. Its growth has not been universal. The total increase of employment in wholesale and trade, all government, and all other, 374,000, is not large but it is against the trend. Manufacturing accounted for 1,416,000 of the decline and more than four-fifths of the total drop was in durable goods manufacturing. It is in this area that the wage-price spiral has been especially prominent. The hourly and weekly wages in construction are the highest in the whole class of wage and salary workers, a fact which may have some bearing on the decline of housing starts.

The question under discussion advances two mutually inclusive alternatives of Government action, and an assumption that by following these sources of action, the Government could counteract a downturn in the economy.

The assumption should be dealt with first. In order to select appropriate measures for counteracting the downturn, or recession, it is necessary to understand its cause. In addition to the points made above, this matter is discussed further in the answer to question 17. In anticipation of that discussion, it can be said here that the alternative courses of action indicated in the question rest, in common, on a fallacious theory of how to regain and retain prosperity.

This is the purchasing power doctrine. It assumes that what the country needs is for the people to have more money to spend. Underlying this doctrine, as an explanation of the recession, must be the further assumption that for some reason a great deficiency of income and of spending has occurred. But this assumption does not fit the facts, for there has been no slump in spending so great as to justify resort to "pump priming" expenditures. Consumer spending in the last quarter of 1957 was at an annual rate above that for 1956, although it was down from $283.6 billion to $282.4 billion as compared with the preceding quarter. Total gross private domestic investment in 1957 was down from 1956 by $2.3 billion, but it was still higher than in any year prior to 1956. The decline was mainly the result of an inventory drop of $3 billion in the final quarter of 1957. The inventory of United States corporations was at an all-time record high at the end of the third quarter of 1957, and even after the corporate

share of the runoff in the fourth quarter, the year-end corporate total was above the average of any previous year. Total Federal spending from budget and trust funds will be around $85 billion in 1958, and the same or more in 1959. State and local government spending will be not far from $50 billion in these years. With personal and business spending at or close to record highs, if total Government spending of some $135 billion would not be sufficient to prevent an economic downturn or to counteract it, once begun, it is a counsel of futility to advocate more public spending. The cause and the cure must be somewhere else.

The aspect of the current recession that is of greatest concern is the unemployment situation. Advocates of more spending seek, by this means, to provide jobs for the jobless. Large public works would mean more Government spending and a tax cut would mean more private spending. In either case, however, the result would be more spending, for the private spending would be added to public spending equal to or in excess of the budget estimates.

Since time is of the essence, there should be no difficulty about the choice. A tax cut would begin to operate at once and its impact would be universal, affecting all taxpayers throughout the country. In contrast, a public works program would have a spotty impact, limited to some communities and some industries. The more worthwhile the projects selected, the greater the delay in starting because of site acquisition, suitable plans, letting contracts, and assembling workers and materials.

The "useful employment opportunities" referred to in the Employment Act means jobs in which workers earn a wage or salary by adding to the total output of goods and services. They do not mean useless activities such as leaf raking, boondoggling, or other forms of made work.

The great danger in "large increases in public works" is that these will include a high proportion of useless projects and made work. The ill repute the rivers and harbors bills have had over many years is well known and well deserved. Other kinds of public works, authorized hastily and without competent justification, are very likely to be of a kind with the traditional "pork barrel" projects. If an increase of purchasing power would really do the trick it could be supplied most expeditiously by printing and distributing more money.

Counsel is divided over the kind of tax cut, if any, that should be made, because of the confusion of thinking in regard to the puposes to be served. The purpose, as conveyed by implication in the above question, is to increase purchasing power. One naive objection to tax reduction is that taxpayers might save some of the cut rather than spend all of it. Because of the obsession over purchasing power, tax gadgets such as higher exemptions, splitting the first bracket rate, or a tax holiday, have found favor. If Government spending were to be correspondingly reduced, a tax cut would not increase total purchasing power, but merely transfer its spending from the Government to the people.

But no reduction of Government spending is intended. Rather, it will be materially in excess of the budget estimates for 1958 and 1959 because of a belief, in Government circles, that more spending now is a good thing, even if such action repudiates the carefully drawn

budget plans. In consequence, the prospect of a sizable deficit is not only conceded, but welcomed by advocates of spending.

Quite apart from the current economic situation, the need for tax rate revision has long been apparent. The President recognized this need in the budget message for 1958, in these words:

"It is my firm belief that tax rates are still too high and that we should look forward to further tax reductions as soon as they can be accomplished within a sound budget policy. Reductions in tax rates would give relief to taxpayers and would also release funds for the activity and investment necessary for sustained economic growth through private initiative."

If the President's conviction has been traslated into action a year ago, the purpose of the tax-rate reduction would have been clear. It would have been to "release funds for the activity and investment necessary for sustained economic growth through private initiative." As long as economic growth is sustained there can be no recession. Now the administration and the Congress are under the gun of a decision about tax cuts intead of tax rate revision. The objective has shifted from sustained economic growth to curing the recession.

It is still not to late to act sensible and courageously. The aim should not be merely a tax cut to cure the recession. Rather, it should be tax rate revision to assure economic growth. Even if a proper, long-range plan for systematic tax rate revision would result in a deficit for 1959, the country would be in no worse position on that account than it would be if the deficit were the result of spending or ill-considered tax cuts. On the contrary, it would be in a much better position because the invigorating effect of the right kind of tax action would promptly expand the taxable income base and thus provide revenue sufficient to eliminate the deficit gap.

There is no dynamic thrust from public works spending or ill-designed tax cuts. At best they constitute a gigantic national dole which would burden us indefinitely because it cannot lift the economy off the ground. In sharp contrast, an orderly, forward scheduling of tax-rate revision would be dynamic, and if it were enacted promptly, the psychology of recession would be dramatically dispelled.

There are various reasons for the relatively static effect of a mere increase of spending through public works or an ill-designed tax cut, as against the dynamic effect of an orderly forward scheduling of tax-rate reform.

First, a mere increase of spending, which would be made possible by a deficit-financed increase of the money supply, would have the result of validating the high wage-cost level produced by the advance of wage rates faster than national productivty. By thus undermining the forces tending to hold down additional wage increases of this sort, it would mean doing business at ever higher wage and price levels instead of increasing the rate of business activity itself. It will be recalled that 4 percentage points of the advance of gross national product in 1957 over 1956 was the product of inflation and only 1 percentage point was real economic growth.

Second, a mere increase of spending would have little effect on incentive. In contrast, the assured prospect of reducing the excessive rates of income tax down to a more moderate level in a series of steps would vitalize the incentives to earn more, save more, invest more in the future growth of the country. As the First National City Bank

letter for March 1958 put it: "The first problem of recovery is to brighten the outlook for profits. This can be aided by forbearance with respect to wage and tax demands on industry."

Third, the prospect of an indefinite series of deficits would delay recovery by impairing business and investor confidence, particularly with respect to the ultimate value of long-term investments. The futility of spending for economic recovery was demonstrated in the 1930's. The aggregate deficit for the fiscal years 1931–39, inclusive, was $24 billion. Gross national product rose from $76.3 billion in 1931 to $91.1 billion in 1939, a net gain of $14.8 billion. The industrial production index moved up during this period by 18 points (on the 1947–49 base) and the wholesale price index showed a net gain of only 2.7 points. Gross private domestic investment rose only from $5.5 billion in 1931 to $9.3 billion in 1939.

On the other hand, any deficit that might be incurred at the outset under a forward scheduling of tax rate reduction would be promptly terminated because of the expansion of the taxable income base as the growth of the economy was resumed.

Fourth, the effect of a sudden injection of a substantial amount of new money into the economy as a result of large-scale deficits would present the threat of resumption of serious inflation. The Federal Reserve authorities would have an obligation to move promptly to curb this inflation before it worked damage and hardship on that large segment of the people who are dependent on fixed incomes. A policy of strict restraint would tend to neutralize any beneficial results that might, even temporarily, follow from the inflation. It would be sheer folly to legislate restrictions on Federal Reserve action aimed at preventing the application of monetary policies of restriction.

The conclusion that has been indicated above is inescapable. Ill-designed tax cuts will prolong our misery. Soundly devised plans for orderly forward scheduling of tax-rate revision will put us back on the highway to economic growth and progress.

Question 14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

Answer. In one respect this question involves relative magnitudes. The total deficits from 1940 through 1946 were $215,027 million. Here is the source of the inflationary conflagration that could not be extinguished. In the 11 years 1947 through 1957 there were 6 deficit years, with a total deficit of $25,696 million, and 5 surplus years, with a total surplus of $15,905 million. The net budget deficit for the 11 years was therefore $9,791 million.

Superficially it would appear that a net total deficit of some $9.8 billion over an 11-year period would be inflationary on net balance. But there were 2 surplus years at the beginning of the period (1947, 1948), 2 at the end (1956, 1957) and 1 in the middle (1951). The surplus years prevented the deficits from having an uninterrupted inflationary effect. It is necessary, further, to consider the extent to which these particular deficits were financed by the commercial banks.

The following condensed tabulation summarizes certain relevant data:

Periods (fiscal years)	Totals for periods		All commercial banks, at end of periods			All banks, time deposits
	Budget surplus (+) or deficit (−)	Debt increase (+) or decrease (−)	Loans and investments	United States governments	Demand deposits	
	Millions	*Millions*	*Billions*	*Billions*	*Billions*	*Billions*
1946	[1]−$20,676	[1]+$10,740	$119.4	$84.5	$98.0	$48.8
1947–48	+9,173	−17,130	113.9	64.8	90.8	54.1
1949–50	−4,933	+5,065	121.8	65.8	95.5	56.8
1951	+3,510	−2,135	126.0	58.5	102.5	57.4
1952–55	−20,763	+19,152	155.3	63.3	113.0	75.5
1956–57	+3,222	−3,847	165.6	55.5	115.7	85.2

[1] These figures are put in to complete the record. They do not enter into the subsequent account, which begins with the opening of the fiscal year 1947, on July 1, 1946.

Certain deductions from these figures are obvious.

First, there was a sharp decline of commercial bank holdings of government securities, partly through redemption and partly through sales made in order to lend or invest in other assets.

Second, there was relatively small commercial bank participation in the deficit financing after World War II—$1 billion out of $5 billion debt increase in 1949–50, and $4.8 billion out of $19.2 billion debt increase in the 1952–55 period. In the answer to question 3 the Federal Reserve Board's emphasis on avoidance of bank participation in the Korean war financing was noted.

Third, there was a steady rise of bank loans and investments other than government securities. The net increase in these items from June 30, 1946, to June 30, 1957, was $76.1 billion. The increase of money supply, as indicated by demand deposits in commercial banks, was $17.7 billion. But time deposits in all banks rose during the period by $36.4 billion. The general view is that time deposits are not part of the money supply, although there is some disagreement with this view.

Fourth, the velocity of circulation, which is not shown in the table, appears to have risen considerably. In 1946 the rate for "other leading cities" was 16.5. For 1957 the rate in 337 other centers (a different sample than that for 1946) was 23. The transfer of a substantial part of the bank deposit credits from a demand to a time status was counterbalanced in some degree by this rise of some 50 percent in the rate of turnover of the active deposits.

As a general conclusion it can be said that in the periods of deficit financing—namely, 1949–50 and 1952–55—there was an increase in the money supply which constituted a potential contribution to inflation. But there were also increases in the supply in 1951 and in 1956–57, when budget surpluses were the rule. A more important factor appears to have been the increased rate of velocity. Finally, the shift of deposits into time accounts held the inflationary pressure at a lower level than would have been the case if all of these deposits had remained in the active demand accounts. It is significant that the velocity rate in the 337 other centers dropped from 24 in August 1957 to 22.9 in January 1958.

Question 15. Can full employment goals be attained while maintaining a dollar that has relative stable purchasing power?

Answer. It was said, in the answer to question 11 (*b*) that the term "full employment" is inappropriate and misleading because there can never be a literal realization of it without drastic police methods to keep everyone continuously at work. The language of the Employment Act, which refers to those "able, willing, and seeking to work," provides a more realistic description of the employment goal. Another way to put it would be the maximum employment attainable in a free society.

The maintenance of such an employment goal and stable dollar purchasing power will depend on whether or not employer can provide jobs, keep people at work, and sell their product for enough to cover costs together with a reasonable profit, within the limits of a given money supply. The principal reason why they might not be able to do this would be an increase of costs such as would require an inflationary injection of new money to keep the business going. And the principal source of cost increase would be the advance of wages at a rate faster than the growth in national productivity. When this kind of disproportion between wages and output occurs, costs are increased because, even if physical units of output are increased, it is the equivalent of paying the workers more for doing less. For a time this excess of wage cost may be offset by technological and other cost-reducing improvements, but this is not likely to continue indefinitely. Sooner or later, the employer faces the choice between a smaller scale of operations, which means some unemployment, or excessive loans to finance his higher costs. When all employers are in this situation, the Government is likely to step in with enough credit inflation to validate the cost of the excessive wage increases.

Maximum employment and stable dollar purchasing power are reconcilable only if wages are kept in line with national productivity.

Question 16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

Answer. No. These provisions become a factor in a spiral of rising costs and rising prices which eventually would compel resort to inflation in order to validate them. Escalator-induced increases of wages in manufacturing, for example, lead to higher prices for manufactured products, which, in turn, are reflected in a higher Consumer Price Index. As consumer prices rise, the cost of living factor or escalator clause in wage contracts produces an automatic wage increase, and so the spiral continues. The higher cost of manufactured goods also increases the cost of the things that farmers must buy, and this affects the parity relationship with higher support prices for major farm products. These higher prices also find their way into the Consumer Price Index and give another boost to the escalator.

Question 17. List and briefly discuss what you consider the causes of the present recession and what should be done to terminate it.

Answer. The present economic situation shows the following characteristics:

1. Recession, as indicated by rising unemployment and falling industrial output.
2. Inflation, as indicated by rising prices.
3. Impaired prospects for long-term growth as indicated by the low level of net growth of business capital and dependence on inflation to support the load of business debt.

One of the causes of the economic condition which is revealed by the above symptoms is the stagnation of profits and the declining prospect of profitability commensurate with effort and risk in business venturers. This should surprise no one, for it is self-evident that profit, or the prospect of profit, is the driving force of our economy. When that prime mover loses power, the ponderous machine which we call the national economy begins to lose momentum.

The source of the squeeze on profits has been the upper millstone of labor costs rising at a faster rate than national productivity and the nether millstone of restrictive money policy. Inflation has been with us for so long that it had become a way of life. The business community had not only become accustomed to it, but had relied on it to validate the steadily rising cost level established by the pattern of wage increases, and also to make endurable the mountain of business debt that had been issued as the principal means of business financing. On the other hand, in the best judgment of the Federal Reserve Board, inflation has been and always will be a menace to stable economic growth and the general well-being. Its credit restriction policy through the third quarter of 1957 did not go so far as to halt all expansion of credit, but it did reduce the availability of credit and increase its cost. It has always been clearly understood that a continually increasing money supply will be required to finance a rising level of costs. In the present instance this rising cost level is caused by excessive wage increases. It has been equally well understood that if the money supply is not increased, the first impact of the squeeze caused by rising cost and restricted money supply would be on profits, which the result that unemployment would follow. In the answer to question 11 (*b*) it was said that employment and economic stability are compatible goals provided that wage increases are held within the limits of the growth in national productivity. The people are paying the price now for disregard of this fundamental principle. They would pay a heavier price, for a longer time, if inflation were resumed and tolerated to permit continued disregard of it.

Excessive income tax rates are a serious impediment to recovery from the recession and to stable economic growth because they weaken the incentives to produce and to save, and particularly the kind of saving that is motivated by intent to invest in equity capital. The return to vigorous economic growth will require resumption of capital formation at a level much above that now prevailing. Healthy financing of new capital must be done, in far greater proportion than heretofore, through equity investment if we are to avoid inflation for the purpose of underwriting business debt financing.

The foremost policy objective now should not be merely to find a cure for the recession but to chart a course that will put the country back on the highway of national advance through economic growth. In achieving this end, the recession will, of course, be terminated.

It is suggested that the main goal can be achieved, and with it the secondary goal of curing the recession, by a combination of three major legislative programs:

1. Legislation to restrain labor monopolies and the power of the large labor unions to raise costs. This will eliminate the condition which forces us to choose between inflation and unemployment.

2. Legislation to reform the income tax rate structure by a forward scheduling of tax rate reductions. This will remove the roadblock to capital formation.

3. Legislation to apply strict economy in Federal spending without impairment of essential national defense requirements. This will leave a maximum share of the Nation's output for the people to use in their own way and to provide for long-term growth.

NATIONAL ASSOCIATION OF FOOD CHAINS,
Washington, D. C., April 2, 1958.

Hon. HARRY F. BYRD,
United States Senate,
Washington, D. C.

MY DEAR SENATOR BYRD: I am sorry that the enclosed statement was delayed by a series of circumstances, but hope that it will serve a useful purpose.

It was prepared by economists in the food chain industry, and represents the views of some industry leaders.

Sincerely,

JOHN A. LOGAN,

COMMENTS SUBMITTED BY JOHN A. LOGAN, PRESIDENT OF THE NATIONAL ASSOCIATION OF FOOD CHAINS, RELATING TO QUESTIONS POSED BY THE UNITED STATES SENATE COMMITTEE ON FINANCE CONCERNING ECONOMIC POLICY AND OTHER MATTERS AFFECTING THE AMERICAN ECONOMY.

I. CONTROLLING INFLATION

Controlling wide swings in the general price level while promoting economic growth in production, demand and employment, is perhaps the most difficult problem facing the American people. Since World War II, increasing international responsibilities, defense needs and the growing demand for other governmental services have resulted in mushrooming Government expenditures. In the same period, the private sector of the economy has been growing at a substantial rate reflecting in part the catching-up process growing out of wartime shortages and the expansion of needs traceable directly to a growing population, a rising standard of living, and improving technology. The combination of large governmental expenditures and a dynamic private economy has taxed all of our resources to the fullest extent. Large-scale unemployment has been virtually nonexistent and there have been only three measurable interruptions in the upward trend of the economy—the 1948–49, 1953–54 and the 1957–58 recessions. The first two of these recessions proved short lived while the third has not yet run its course.

The postwar period has also been characterized by a rising price level which in turn was interrupted only by the recessions previously noted. In three distinct periods, 1946–48, 1950–53 and 1955–57, the price level advanced rapidly, giving rise in many quarters to the fear that price stability is an unobtainable objective and that price inflation is inevitable. There is no evidence to be gleaned from our postwar experiences which can be cited to refute this view although it should be recognized that our Government's monetary and fiscal powers have not been closely coordinated in the fight against inflation at any time in recent years.

Prior to the accord between the Treasury and the Federal Reserve System in 1951, the latter was ineffective in combating inflation primarily because of its policy of supporting the prices of Government securities at or near par. This policy permitted the banking system access to a supply of reserves while avoiding any substantial losses on securities sold for this purpose. As a consequence, the banks found it possible to expand loans and investments in direct relation to demand.

Following the accord, however, the Federal Reserve gained effective control of bank reserves and hence the creation and extinguishment of bank credit. Some critics point to the 1953–54 period arguing that the extreme monetary ease fostered by the Federal Reserve led to the rapid inflation of the last 3 years. Others might well find fault with Federal Reserve timing at several points in the 1955–57 period, but it should be noted that these failings seem clear only in retrospect. Recognizing the limitations of Federal Reserve powers, monetary policy has been a successful force in realizing the objectives of the Employment Act of 1946 including that of promoting economic growth in production, demand, and employment and moderating the upward bias of the price level. It might be interesting to speculate about the possible extent of the rise in the price level in the years 1955 through 1957 had the Federal Reserve not pursued a policy of monetary restraint as it did.

Fiscal and other Federal Government activities have not contributed particularly to the curbing of inflationary forces in recent years. The surpluses in the Federal cash budgets of the calendar years 1956 and 1957 were relatively small. Government expenditures at the Federal and local levels have been rising steadily since 1955 when inflationary pressures were developing. Ignoring defense needs, international and domestic problems and political factors, expenditures might logically have been cut and/or tax rates raised in that period in the interest of slowing the rise in the price level and the improvement in overall business activity. However, the Federal Government has not been in a position to follow a truly compensatory fiscal policy at any time during the postwar period with the exception of the 1953–54 recession when timely tax cuts took effect and stimulated the economy.

While thoroughly coordinated and implemented monetary and fiscal policies hold some promise in achievement of price stability and full employment, there is one area where the logic of the situation and observed facts indicate that a certain relationship must exist if a stable price level is to result. Reference in this case is made to wage rates and the need to keep the increase in the general average of wage rates within the limits of the increase in the average level of productivity. Without this condition, no public or private action can be more than partially successful in providing both stable prices and full employment. With this condition satisfied, however, a variety of policy combinations might conceivably succeed in preventing inflation.

Compensation of employees makes up about 70 percent of the national income and consequently constitutes the bulk of the spending power in this country. It is inconceivable that any sustained rise in the price level could occur without a rise in employee compensation sufficient to sustain it—that is, a rise in employee compensation greater than the rise in production. If the rise in employee compen-

sation is kept within the limits of the rise in physical output or if employee compensation per man-hour increases no more rapidly than output per man-hour, then any sustained rise in prices would be inconceivable. Any attempt to raise prices would merely result in reduced sales because the general public would not have the wherewithal to pay these prices.

With employee compensation contributing such a large fraction of total national income, the argument over whether inflation is caused by a "demand pull" or a "cost push" is to a large extent irrelevant; in either case it is employee compensation which is the source of the pull or the push. What happens in the area of profits, farm income, or the income of proprietors and professional people is relatively insignificant by comparison. In fact, it has been suggested that the price level is a function of wage costs pure and simple.

Examination of the facts suggests the same thing. The comparison of sales with compensation of employees for all United States corporations, indicates that the relationship has been amazingly close since 1929. This is what one would expect from the theoretical considerations. The relationship between the broad price indexes and employee compensation per unit of real sales is also very close.

The conclusion thus seems inescapable. The question of controlling inflation involves finding ways and means of holding the rise in employee compensation to the limits set by the rise in production. Attention must be focused at the place where wages are determined, that is, at the bargaining table between labor and management. For it is here where restraint must be exercised if at all. We require a general understanding by the public that our standard of living can only be improved through greater productivity and not at all through general increases in wages beyond the growth in productivity.

Our inflation problems are traceable directly to the pattern-setting industries, namely autos, steel and other metals. For example, the Ford settlement of 1955 touched off a round of annual wage increases which were not only in excess of productivity but were built in for successive years in long-term contracts. This inflationary pattern of recent years cannot be altered successfully unless the general public understands the consequences of these contracts, supports legislation that will equalize power at the bargaining table and thereby provide the means for effective resistance to increases in wages exceeding increases in productivity.

II. OBJECTIVES OF ECONOMIC POLICY

In light of the present world situation requiring as it does huge defense expenditures and substantial amounts of foreign aid to our allies and underdeveloped nations, the prime objective of economic policy in the United States must be the promotion of economic growth in production, demand and employment. Mere stability in production, demand and employment over the long run will result in increasing real costs of our defense programs and lessen our ability to bear the burdens of free-world leadership. Continued advancement in science and technology upon which an effective defense effort must be based is also the foundation for an expanding capacity to produce a greater volume of nondefense goods and services.

The objectives of rapid economic growth and broadened defense capabilities are mutually consistent and reinforce each other.

Employment of 95 percent or better of the labor force is a desirable objective in our society. If realization of this goal should conflict with maintaining a stable price level, there is little question about which goal would be chosen by the American people. The first aim is to maximize the production and income of the country.

However, the goal of maximum production and real income under the free-price system can best be achieved with a stable general price level. A stable price level offers the most concrete base for the formulation of plans by businesses and individuals, and the making of contracts which extend over a period of time, thus contributing to efficiency. It avoids the inequities that result from changes in the purchasing power of the money unit.

III. THE CURRENT RECESSION

On the basis of the facts now available, the current recession stems largely from the liquidation of inventories primarily at the manufacturers' level and from a general decline in plant and equipment expenditures beginning in the fourth quarter of 1957. Nearly all of the dollar change in the gross national product account in the fourth quarter of last year is directly attributable to a swing of $5.7 billions in inventories between the third and fourth quarters. The dollar decline in plant and equipment expenditures amounted to about $1.5 billion in the final quarter of 1957.

The current recession thus resembles those of 1948–49 and 1953–54 from the standpoint of causation. It remains to be seen whether the 1957–58 decline will be reversed shortly in the pattern of the other two postwar recessions. The answer depends to a large extent on the timing and magnitude of Government action in the fiscal area. This, however, should not be regarded as a substitute for earnest, intelligent action by private industry to stimulate business confidence and action.

With respect to palliatives, the Federal Reserve has completely reversed its policy of monetary restraint in effect through the fall of 1957 and has since moderated the decline in the money supply and has brought about a drastic change in the level of interest rates. On the other hand, the Treasury has proved to be a disruptive force in the money market since last November, offering several issues of medium- to long-term bonds in an attempt to lengthen the average maturity of the public debt. These offerings were made in direct competition with private offerings and increased congestion in the long-term bond market. In this way, the Treasury offerings neutralized in part of the efforts of the Federal Reserve in promoting monetary ease. It now appears that the April Treasury financing will be placed in the short-term sector of the money market thereby contributing to the effectiveness of Federal actions.

Late in March 1958, it is difficult to find evidence that Government action on the fiscal front designed specifically to curb the downward trend in busines has yet been sufficiently effective. The cumbersome nature of the expenditure side of fiscal policy as it is used in fighting a recession is illustrated by the fact that although many proposals are being debated in Congress, few positive steps have been taken. Ex-

penditures of the Federal Government are trending slowly upward. It may well develop that Government expenditures will not increase sharply until after the economy has bottomed out and an upward trend is underway. Accelerating expenditures at that time might reinforce the upturn and complicate the problem of maintaining a sustainable rate of growth in the economy and a stable price level.

The revenue side of fiscal policy is being debated vigorously and the administration is resisting an immediate tax cut apparently because of the spector of budget imbalance a year or so in the future. Political factors aside, tax cutting remains one of the most effective weapons in the hands of the Government, its flexibility nearly matching that of monetary policy. Many economists have called for an immediate tax cut. The logic of this argument is difficult to deny. An across-the-board tax cut seems advisable in the present situation and such a move is clearly preferable to a broad increase in expenditures for public works and other projects which cannot easily be terminated when the need of stimulus to the economy passes.

In considering the tax-cut measure, it would be appropriate to examine the possibility of revising the overall tax structure in an effort to eliminate long-standing inequities. Reference in this case is made to certain of the excises and the personal income tax which might well be revised in the interest of increasing incentives and productivity. To quote a recent report of the Joint Economic Committee, "Constructive tax revision aimed at greater neutrality in the impact of our revenue laws on the ways in which taxpayers use the resources at their disposal has become more urgent than ever in light of the new challenges currently confronting the Nation." However, studies of basic revisions in the tax laws should not delay an immediate tax cut designed to accelerate the recovery in business.

IV. THE FUNCTION OF DEBT

Private debt has grown sharply in recent years in contrast to the near stability of the public debt. In fact, in the 10 years ended in 1955, the growth in the private debt accounted for about 90 percent of the increase in the gross debt of the people of the United States reflecting the rapid acceleration of spending in the private sector of the economy and approximate balance in governmental accounts.

The growth of this debt also reflects the equally rapid gain in the savings capacity of the American people since debt instruments represent the most important means by which savings are channeled into productive investments. For this reason, the vitality and the growth of our economic system are directly measurable by the increase in debt, whether it be public or private. Thus, as the economy expands, so so will the aggregate debt.

There is little doubt that debt creation and extinguishment are potentially destabilizing forces as far as the total economy is concerned. This, after all, is the rationale of an effective monetary policy. Monetary restraint such as applied by the Federal Reserve in the last 3 years limits the expension of credit and hence the growth in debt. In contrast, a policy of monetary ease such as that now in effect in this country encourages the creation of debt and the expansion of credit.

It is the function of monetary policy to limit the growth in debt to a sustainable rate. Otherwise, unbridled debt expansion will pave the way for contraction in the economy and deflation.

CHARLES TOWN, W. VA., *April 15, 1958.*

Hon. HARRY F. BYRD,
Chairman, United States Senate Committee on Finance,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: In accordance with your request of February 17, 1958, I am enclosing herewith a memorandum on the problem of price stabilization. It has seemed to me that I could make a more useful contribution by means of a carefully prepared analysis than through answering a series of questions.

Trusting this will be of use to your committee,

Sincerely yours,

HAROLD G. MOULTON,
President Emeritus, The Brookings Institution.

Enclosure.

MEMORANDUM FOR UNITED STATES SENATE COMMITTEE ON FINANCE

This memorandum will be focused not on the maintenance of economic prosperity but on the problem of preventing inflation. It will be divided into two parts: (1) What forces have been responsible for the great rise in prices in recent times—since World War II; and (2) Can the price level be controlled by Government policies?

I. According to traditional economic analysis a general rise in prices is caused by a disproportionate increase in the quantity of money in circulation as compared with the quantity of goods. The increased money supply is usually said to be the result of credit extensions either by private banking institutions or by the Government. During the period here under review Government deficit financing is commonly held to be of primary importance.

Since the end of World War II price movements show no correlation with the state of the Federal budget. The following facts should be carefully noted:

1. The period of most rapid postwar price advances was in the years 1946–48. In the last fiscal year of the war period, ending June 30, 1945, the cash deficit had been $49.5 billion. In the ensuing fiscal year this was reduced to $7.4 billions; while in the fiscal years 1947 and 1948 there were cash surpluses of $19.4 billions and $7.3 billions, respectively.

2. The next sharpest advance came between June 1950 and February 1951. In the fiscal year ending June 30, 1950, there had been a cash deficit of $4.2 billion. But in fiscal 1951 there was surplus of $5.8 billion.

3. The latest substantial advance in the wholesale price index came in 1956–57. In the calendar years 1951 through 1957 there was again no correlation between price trends and the budget situation. The table which follows shows the net yearly results of Treasury operations (cash basis) and wholesale prices during these years.[1]

[1] Annual Report of the Secretary of the Treasury, June 30, 1957, p. 400.

Year	Net surplus or deficit	Wholesale price index
	Millions	
1951	+7,593	114.8
1952	+49	111.6
1953	−5,274	110.1
1954	−232	110.3
1955	−2,702	110.7
1956	+4,471	114.3
1957	+2,099	117.6

In the deficit fiscal years 1953, 1954, and 1955 prices remained practically stable. In 1956 and 1957 there were substantial surpluses; meanwhile prices rose sharply.

One should not of course conclude from this inverse correlation that surpluses cause rising prices and that deficits cause falling prices. As we shall later see, the factors responsible for the price trend were nonfiscal in character. It should be added that the fact that budget deficits do not necessarily cause price advances does not of course warrant the conclusion that the state of Treasury finances and the growth of the public debt is a matter of no importance. For other reasons the maintenance of fiscal stability is a fundamental requirement.

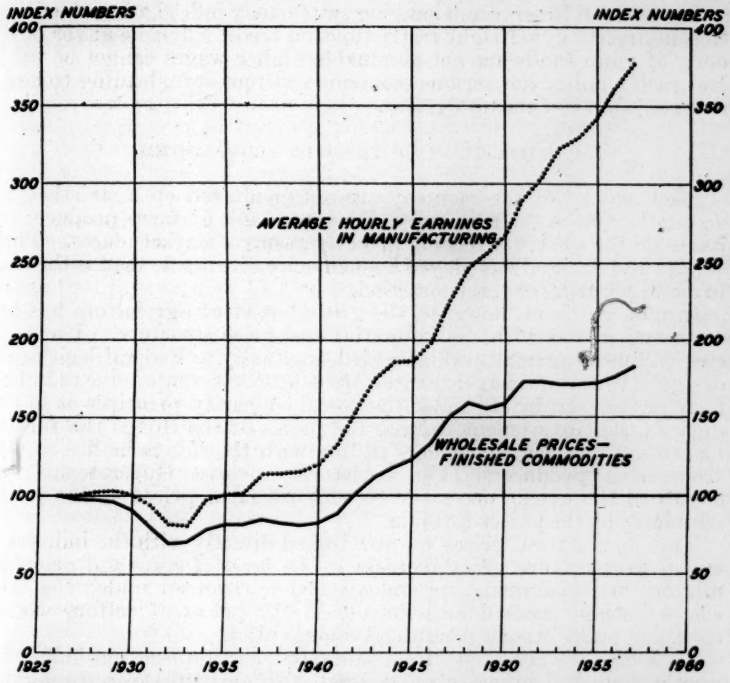
HOW MONEY GETS INTO CIRCULATION

The assumption has long prevailed that when credit currency is created the money supply is automatically increased without any corresponding increase in the quantity of goods. When more money is spent for the same goods the result is said to be rising prices.

This conception ignores the process by which money gets into the channels of circulation. Money gets into the hands of the people almost entirely through pay envelopes—enclosing wages, interest, rents, and dividends. The national income available for expenditure or saving is simply the sum total of the disbursements for wages, interest, rents, and dividends. In addition there are minor outlays for relief and subsidy. There are no other circuits through which money reaches the people. Hence, the supply of money as compared with the supply of goods is governed by the ratio of rates of pay for services rendered to man-hour output.

The supply of money as compared with the supply of goods will increase only if more money is paid out for the same productive output than formerly. Since wages and salaries account for over 70 percent of the total money income—rates of pay for work done are of decisive importance. The significance of the wage cost factor may be indicated as follows: At the present time a general increase of 10 percent in wage rates would increase money in the hands of the people by roughly $25 billion a year—an increase which manifests itself first as a cost of production.

The accompanying chart shows the trend of hourly earnings in manufacturing as compared with the movement of wholesale prices from 1926 through 1957. During the greater part of this period and especially since World War II wage rates have risen progressively faster than the wholesale prices of finished commodities.



This progressive increase in rates of pay is a primary cost factor—exerting an unrelenting pressure toward higher prices. While prices did not rise as fast as wages, profits were nonetheless well sustained. This was of course made possible by the offsetting gain from the increase in productivity that occurred during this period. Man-hour output did not however increase in proportion to rates of pay.

CAN MONETARY AND FISCAL POLICY PREVENT INFLATION?

The money income available for expenditure cannot be directly controlled by either Federal Reserve or Treasury policies. Since neither the Federal Reserve nor the Treasury is vested with power over wage rates, they cannot prevent more money being paid out for a given volume of production. Wages may rise irrespective of deficits or surpluses in the Treasury. Whatever the state of the budget, if wages and other costs are rising, prices will rise.

Raising interest rates cannot prevent a long-term upward price trend based on rising costs. Since the Federal Reserve officials have not been vested with authority over wage or other contracts they have no direct control over costs. To stabilize prices it would be necessary first to stabilize wage rates, interest, rental rates, customs duties, and excise and sales taxes.

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The Federal Reserve and banking system may indeed affect the situation indirectly by outright restrictions on credit extensions; for obviously if more funds are not obtainable higher wages cannot be paid. But such a policy has serious economic repercussions, leading to business recession and unemployment.

RAMIFICATIONS OF THE COST-PRICE SYSTEM

Some sectors of the economy are not conducted on a strictly cost accounting basis. Historically, the great bulk of farm produce has been sold for what it will bring in local or central market places. Thus supply and demand has played a much more direct role than is the case in manufacturing or transportation.

In modern times, however, the greater part of agriculture has become articulated with the industrial cost-price structure. The relative decline of agricultural prices led eventually to Federal legislation designed to maintain agricultural prices at levels comparable to industrial prices. In brief, under the so-called parity principle it is the duty of the Government to keep the prices of the things the farmer has to sell to urban consumers in line with the things he has to buy from urban producers. The mechanism involves Government purchases to the extent necessary to support farm prices at the levels stipulated by the parity formula.

Thus agricultural prices are now linked directly with the industrial cost-price structure. Any increase in the level of costs and prices in mining, manufacturing, or transportation requires, under the law, compensating, upward adjustments in the prices of cotton, wheat, corn, and many other agricultural commodities.

To follow the complete circle of interconnection between industrial and agricultural prices, we may start with an increase in wage rates in the steel industry. A resulting advance in the price of steel products means an increase in costs over the wide range of industries using steel—notably transportation, construction, hardware, farm machinery, and automotive vehicles. These advances in costs shortly find reflection in the prices charged by these industries for their goods and services; and in turn (through the operation of the parity system) in the prices of farm produce and foodstuffs. In due course, the rising cost of retail prices of foodstuffs impels demands for compensating increases in wages. Where the escalator principle is incorporated in wage contracts, an automatic upward adjustment of wages is guaranteed. In this example we assumed the initial impetus came from wage increases in the steel industry. A similar sequence would follow whether the initial advance was in steel or transportation, or some other industry; and whether it began with wage increases, or independent advances in prices.

The impact of industrial price advances is soon felt throughout all sectors of the economy. A rise in the price of manufactured goods directly affects the costs of construction and supplies required by financial and service agencies, hospital and educational institutions, and in the manifold activities of Governments, Federal, State, and local. Moreover, as the cost of living increases, compensating increases in salaries, wages, fees, etc., become necessary in every field of activity. Finally, the rising costs of Government operations necessi-

tate increased taxes which in some cases become a part of the industrial cost structure.

GAGING THE FUTURE OF PRICES

Two factors will be of decisive influence in determining the future trend of prices: (1) the rate of technological progress—which governs the output per man per hour; and (2) the wage and salary rates paid to employees. Increasing productive efficiency—a cost-reducing factor—exerts pressure toward lower prices. Increasing wages—a cost-raising factor—exerts pressure toward higher prices.

The outcome in the years ahead will reflect the relative weight of these factors—man-hour output and rates of pay. To state the alternative possibilities in simplest terms: (1) If rates of pay and man-hour output increase equally, prices will be nearly stable; (2) if rates of pay increase faster than productivity, prices will rise; (3) if productivity increases faster than wages, the price trend will be downward, assuming of course the existence of effective competition.

It is impossible to know whether the recent rate of technological progress can be maintained or increased. Since World War II we have witnessed an extraordinary burst of creative energy, resulting in a vast expansion of improved industrial plants, with installed equipment of ever-increasing efficiency. Another factor serving greatly to increase aggregate annual output in recent years has been a minimum of strikes and a sustained high level of operations. Thus one may well question whether the recent rate of increase in man-hour output can be sustained indefinitely. However, former fears that we shall soon be faced with decreasing productivity because of the exhaustion of virgin resources have been virtually eliminated. Even in agriculture, modern science and technology are combining to produce much higher yields per acre than was formerly deemed possible.[2]

On the cost side, it appears certain that continuing increases in wage rates will be a powerful force working for progressively higher prices of industrial products. The wage items (embedded in raw materials, transportation, fuel, and power, as well as directly in the manufacturing process) has, as we have seen, become of preponderant importance. And the economic and political power of modern labor organizations is such that continued pressure for higher rates of pay is to be expected. Escalator clauses in labor contracts, designed to lessen industrial strife, serve nevertheless to accelerate the inflation process.

The advance in wage rate, one may venture to guess, will in the future, as in recent years, continue to outstrip improvements in productive efficiency. If so, we shall have a progressive increase in the general level of commodity prices over the coming decades. Only a depression of major proportions, resulting in a substantial reduction of wage rates would reverse the trend. Even in such an event the upward movement would doubtless be resumed in the not distant future.

Respectfully submitted.

HAROLD G. MOULTON,
President Emeritus, the Brookings Institution.

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[2] For extensive discussion of the adequacy of our national resources, see the author's Controlling Factors in Economic Development.

NATIONAL GRANGE,
Washington, D. C., April 14, 1958.

The Honorable HARRY F. BYRD,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: In response to your letter of February 17, I am setting forth in the attached statement a number of my views relating to the Nation's economy. By the nature of things, I have not been associated closely enough with some of the matters included in your list of questions to venture informed comment. I have, however, given serious thought to the subject matter you have presented and I appreciate the privilege of submitting my views for consideration of the Senate Finance Committee.

May I say that you and the members of your committee are performing a vital public service in your current investigation of the financial condition of the United States. This is a matter of critical importance and on behalf of the National Grange I take this opportunity to express our appreciation and deep interest in your efforts.

Respectfully yours,

HERSCHEL D. NEWSOM, *Master.*

OPINIONS ON THE STATE OF THE NATION'S ECONOMY

By Herschel D. Newsom, master, the National Grange, in response to questions presented by the chairman of the Senate Finance Committee in connection with an investigation of the financial condition of the United States

It may be elementary but it is well worth reemphasizing that a basic objective in the operation of the Nation's economic system should be the attainment of an economic equilibrium in the system with a maximum of harmony between the major forces functioning in it.

Such equilibrium and harmony are obviously difficult to attain, especially since the many national and international elements influencing the character of the economy annually grow more complex. As a consequence, every possible effort must be made constantly in this direction, because the very survival of the American form of government is at stake.

The continuing test of strength between the free world and the Communist world, widely known as the cold war, is fundamentally a battle of economic strength. Any prolonged weakening in our domestic economy would surely decay the foundations of the anti-Communist drive.

Even aside from considerations of the cold war, if that were hypothetically possible, we are dedicated in the United States to the proposition that a capitalistic system can continue and flourish, providing for the people a degree of progress, freedom, and prosperity unmatched by any other system. Our present responsibility, therefore, is to demonstrate that capitalism is equal to the pressures and requirements of the industrial-atomic age.

As the Congress has fortunately recognized, there is ample reason to be persistent and deliberate in the current investigation of the financial condition of the United States. New dimensions are functioning in our economy. For example: Unprecedented concentrations of economic power have developed in both industry and labor. Taxing and spending for military-economic defense operations have reached critically high levels. The public debt with its accompanying charges has risen to an unparalleled height. And the magnitude of Government expenditures for all purposes has grown to a point that it significantly affects the entire economic structure.

Familiar economic elements are not acting in familiar ways. Commodity prices have been advancing, for example, during a period of declining consumer buying and rising unemployment. Inflationary and deflationary forces are at work simultaneously.

The traditional conceptions of inflation and deflation are being challenged by the abnormal experience of the current decade.

Classic definitions of inflation are now less than serviceable. It is not adequate, for example, to call inflation an abnormal increase in the quantity of purchasing power, or a situation of too much money chasing too few goods.

There are no critical or even widespread shortages of consumer goods. Stocks of most items have been more than plentiful. In many parts of industry, as in agriculture, productive capacity is not being fully utilized and production schedules have been cut back in response to slackening demand on the part of consumers.

Nor can it be said that there is an abnormal or even unusual quantity of purchasing power bidding up the prices of goods.

There is not, in short, a big excess of demand over supply—the circumstance long regarded as basic to inflation.

Inflation has now become something different and more complicated. To attempt to define it, in the light of currently inconstant conditions, is a hazardous business. At this stage, however, inflation appears to be a continuing decline in the value of money as the consequence of continuing institutionalized adjustments upward in the valuations of goods and services.

For the time being, at least, developments within our system have permitted the pressures for higher commodity prices, wages, rents, and compensation on the part of major sectors of the economy to overbalance the downward pressures traditionally expected and derived from a vigorous competitive situation.

En bloc adjustments upward in wage scales for entire industries, for example, and industrywide price increases for commodities and manufactured items have been a significant element in the institutionalized, massive upward pressure. Relatively unorganized but also concerted have been the progressive upward movements in rents and in compensation for personal services of virtually all types, including the trades and professions.

As each institutionalized sector of the economy has capitalized on its opportunities for upward revision, it has generated action in other sectors for what may be called compensatory increases.

The timing and amounts of the increases have in all instances been deft and this has been a notable characteristic of the entire upward progression. Almost invariably the intervals between increases, and the sums involved in each increase, have had the appearance of mod-

eration or reasonableness. By avoiding the flagrant, no direct countervailing reaction on the part of consumers was ever set in motion. The current decline in consumer purchasing has little of the aspect of a buyers' strike.

A major reason for the relatively passive acceptance of the institutionalized rises that have served to depreciate the value of money, has been the cushioning role of agriculture in recent years. Agriculture alone among the major segments of the economy has been unable to organize itself for purposes of institutional bargaining or compensatory increases.

Farm income has declined progressively since the war period. As a result, increases obtained for transportation, processing, distribution and other aspects of food marketing have not been passed along to consumers in the form of corresponding increases in the prices of food items. Farmers have absorbed an important share of the increases and to this day continue in a disadvantaged position, with no reasonable recourse against the progressive rise in their costs and taxes.

To the extent that farmers have absorbed potential increases in food-item prices, they have smoothed the way for the upward progression elsewhere in the economy, but at the cost of increasing imbalance.

The classic consequence of progressive inflation is, of course, deflation—on the theory that "all that goes up must come down." If the deflation is severe, it customarily bears the name of recession or depression.

Deflation is a condition marked by a reduction in the volume of money and in the velocity of its movement, with a consequent reduction in the volume of purchasing power.

Part of the parodox of the day is that we appear to be experiencing simultaneously aspects of both inflation and deflation.

As prices have been moving upward in recent years, the supply of money has not increased proportionately. Indeed, increasing amounts of money have been siphoned out of normal channels of capital investment, savings, and private consumption by the progressive growth in Federal, State, and local tax levies.

The economic implications of current Government spending, especially for military equipment and services in this era of intercontinental missiles and hydrogen bombs, have not yet been adequately appraised. There is reason for the strong belief, however, that Government spending of the present magnitude not only bids up the prices of services (and certain categories of goods) but reduces (through taxation) the volume of effective consumer purchasing power.

The fact of the continuing "cold war" adds fresh complications to our already complex problem—the attainment of economic equlibrium in a capitalistic system where the forces of competition have been blunted, at least.

Because of the cold war we find justification for the unbalanced budget and an ascending public debt. Defense requirements serve to subordinate peacetime standards of "pay-as-you-go."

Obviously, survival of the Nation in the cold war supersedes all other consideration. We are assuming obligations and making expenditures directly and indirectly related to the war because the circumstances do not appear to allow any acceptable alternative. Until

the international issues can be resolved, the United States cannot do otherwise than prepare its defenses and use its resources in every way calculated to assure us, ultimately, of a satisfactory conclusion.

Even aside from these enormously unsettling effects of the cold war, it must be recognized that the economy of the United States is a dynamic thing, undergoing constant evolutionary change.

The development of automation, the concentrations of economic power in large sectors of industry and labor, the rapidly expanding population, the expanding influence of governmental fiscal policy, the mounting importance of consumer attitudes, and the enunciation as Government policy "the full employment" concept, have all introduced new influences into the ever-shifting structure of the American economy.

These are not the only new and modifying elements, of course, but they are indicative of the economic inconstancy of our times. They point to the utter necessity for a continuing analysis of the American economic scene in order to provide the Nation and Congress with the best informed basis for actions in behalf of harmony and balance in our system.

They also point to the intricacy and interrelationship of the varied elements in our economy. The effect of any single factor can be appraised most usefully in terms of its relationship with the others.

The effect of deficit spending by Federal, State, and local governments since World War II, for example, was undoubtedly inflationary—if this spending could be isolated from the functioning of other factors. Under cold war circumstances, however, this spending may also have served as a vital determent to the deflationary tendencies of heavy taxation and expenditures for military weapons and equipment.

Management of the public debt, the functioning of escalator provisions in wage contracts, the level and timing of public-works programs, the managed contraction and expansion of credit, and the character of taxation are among the other major factors which modify, each in their own way, the Nation's economic balance. It is the aggregate effect, however, which must concern us.

In steering a course toward economic equilibrium, we also need to evaluate on a continuing basis the economic reaction of business management and the consuming public to events and circumstances which influence attitudes. At what point, and for what reason or set of reasons, does the attitude of a vast segment of the population change from one of confidence to caution—or from a disposition to buy instead of to save?

Intangible factors are also present in critical decisions by business and industry. As management undertakes to estimate consumer attitudes and business probabilities, it may decide to move boldly or proceed conservatively with respect to capital investment, expansion, and the willingness to assume financial obligations.

Nothing less than the most expert and objective analysis, carried on continuously, can be counted on to provide a reliable evaluation of the influences being exerted by the various factors of the economy—and their aggregate effect in the direction of inflation or deflation. Nothing less than such an analysis will provide the information and

the guidelines essential to intelligent actions in and out of Government in behalf of economic equilibrium.

Under the Constitution, the Congress has the responsibility for making the basic fiscal and monetary decisions of the Nation. The manifold responsibilities of individuals of Members of the Senate and the House of Representatives, however, are well recognized. As the economy of the United States has become increasingly more complex, and vital, the Congress has faced an increasingly difficult and time-consuming job in appraising and understanding all its aspects.

The executive branch, under these circumstances, has been forthright in advocating fiscal and monetary policies. Yet each administration holding the Executive offices properly and naturally represents a particular economic viewpoint. This is not necessarily a comprehensive or completely objective viewpoint. Moreover, the opportunity is present, whether or not it is used, for political modifications of economic positions.

Considering the unsurpassed importance of economic policy and governmental economic action on the well-being and destiny of the Nation, these circumstances are less than satisfactory. As at least one major improvement, Congress should provide itself on a permanent basis with an advisory economic body of the most capable men available in the country.

Such a body or congressional Commission on Economic Affairs should be invested with a status commanding the highest possible degree of congressional and public confidence in its proficiency, integrity, and dedication to the national well-being. Obviously its membership should be selected without political consideration. Tenure in office and remuneration should be commensurate with the caliber, dignity, and scrupulous independence required of men engaged in such high assignment.

As the economic arm of the Congress and its appropriate committees, such a body could engage in a continuing, comprehensive analysis and evaluation of the elements influencing the Nation's economic health, serve as expert counsel to the Congress during its consideration of economic matters, and help to enhance the accuracy, speed, and effectiveness of the Nation's economic decisions.

NATIONAL FARMERS UNION,
Washington, D. C., April 8, 1958.

Senator HARRY F. BYRD,
Chairman, Senate Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: This is in reply to your letter of February 17, 1958, requesting certain information concerning the state of the economy and the growing numbers of unemployed.

May I say, Senator, that one of the major aspects of the situation that comes to my attention daily is the long-continued drop in farm prices and farm family incomes brought about by reduced effectiveness of the Federal farm income improvement program, by the tight money and high and rising interest-rate policies, and by the ever-increasing processing and marketing margins in the food industry and higher prices for the industrial products and professional services that farm families must buy for production and family living.

1. Deflation (from the agricultural standpoint): It's when the income level of the farmer declines (regardless of cause or actual direction of its movement, i. e., up or down or unchanged) in relation either to (1) his own past income level or to (2) the general income level of the country. In the first instance, the farmer's debts become more burdensome and/or the returns on his investment (land, equipment, labor, etc.) fall. In the latter case, there is the added disadvantage that the cost of things he buys currently will be rising relatively, in reflection of the increase in the proportion of the national income going to nonfarm.

Inflation (same standpoint): In general, this is the opposite of deflation, as defined above. However, it is questionable whether the term should be applied to an incline in the farmer's share of the national income until it approximates full parity with nonfarm income. This share now stands at less than 50 percent of parity, taking account of the farmer's investment, labor input, management responsibilities, etc. Inflation, of course, lowers the relative buying power of money received from fixed agricultural investments drawing fixed interest rates. It also tends to drive up the price of farmland, too often to a level that proves burdensome, if not disastrous, to the purchaser when and if there is a drop in farm income later on.

One of the anomalies of the past few years, of course, has been the deflation of the farm economy of this country taking place at the same time that the nonfarm aggregate was subjected to inflation.

2. Our Nation should maintain a constantly expanding economy equal to growing population and productivity per man with adequately distributed income and leisure such that human values will be at a maximum and all that is produced can be purchased and invested or consumed. Many changes in existing laws are required, some of which will be specified below.

3. The monetary controls prior to 1950 seemed, in my view, to meet the needs rather well. Since 1951, it has seemed to me that the pro-

gram has been operated more in the interest of large bankers and strong industrial corporations than in the general interest.

4. Certainly an outstanding factor in the decline of the dollar's value has been price administration by oligopolistic corporations to whom our laws and customs had given, either by commission or omission, the authority and right to exercise control over price through control over market supply. The most dramatic example, of course, is the steel industry which deliberately raised prices by $6 per ton and cut production, by this week to as low as 49.7 percent of capacity.

5. Management of the public debt and related monetary and credit policies of the Federal Government determine the rate of interest and the supply of money which have a pervading effect upon the rate of investment and of consumer expenditures in a multitude of ways.

6. Insofar as it is consistent with other national goals, the Government should maintain price stability. The national economic policy should be to maintain full employment with adequate leisure and opportunity for full development. Under current circumstances this can only be attained through continuous economic growth of consumption, demand, and production. To the extent that a growth rate required to maintain full employment is allowed to result in price inflation, the required institutional changes should be initiated so that these aims will not in reality be inconsistent.

The record since August 1956 seems to indicate clearly that monopolistic, administered pricing brings about price inflation even when unemployment is increasing and income deflationary forces are at work. This calls for means to require that boards of directors of such firms take national economic goals into consideration in establishing their production and price policies.

7. State and local governments in many cases are spending just about all they can afford or should be asked to spend, considering their sources of revenue and their current taxation devices. Federal expenditures have not been large enough nor directed to high priority national goals. Because it is based primarily on ability and can get at taxable wealth no matter where it moves, the Federal system of raising revenue permits of more equitable treatment both in collection and distribution.

8. Existing local, State and Federal tax systems, taken singly or combined, insufficiently promote an appropriate balanced national economic growth, provide unfair loopholes to a privileged few and place unfair heavy burdens upon those less able to pay.

9. I subscribe to the following paragraphs of the National Farmers Union program adopted by delegates to our recent national convention in Denver:

"National monetary and credit policies should be designed to make adequate funds available at minimum rates of interest so that desirable productive investment will be encouraged. Selective controls should be used to curb inflation if it occurs, and monetary and credit policies should also be used to maintain a positive expanding full employment economy.

"Federal budgetary policies should be geared to the needs of an expanding full employment economy with capital items separated from other expenditures and the cash budget separated from the authorizations budget."

10. (*a*) The United States monetary and credit or fiscal systems the past 5 years have been used as a sort of price-support program for large bankers and have contributed practically nothing to maintaining and fostering an expanding full employment economy with price stability, and distribution of income such as to sustain continued expansion.

(*b*) See 9 above.

11. (*a*) The paradoxical simultaneous existence of unemployment and inflation is due to the administration of prices through monopolistically maintained control of market supply on the part of huge agglomerations of economic power in key industrial corporate firms.

(*b*) Inflation of prices is not a necessary condition of full employment; but if necessary institutional changes are not made to make the two goals consistent, then I would prefer to have a little inflation rather than a lot of unemployment.

12. I believe that production conditions and the structure of distribution of goods and income should be so arranged that the minimum amount of credit is required to enable enterprising young people to acquire and operate the kinds of business investments and family living facilities they need without having to go into debt and thus take on the added burden of interest payments. To the extent that credit is needed to provide for private expansion that cannot be financed out of past income, funds should be made available for such productive and legitimately needed uses at an interest rate approaching as near to zero as administrative costs and the risk element will permit. Since credit resources arise in large part these days from national economic policy and not as the result solely of savings out of past income, there is no valid justification of interest charges to pay what many decades ago might have been necessary to obtain savings through inducing postponement of consumption by private citizens.

13. When the real per capita income of any economic group quits rising, it is time to take selective action with respect to the economic problems of that group. Certainly counterrecessionary action should be initiated at any time when the number of unemployed begins to rise, seasonally adjusted, to more than 2.7 percent of the civilian labor force. Major action should be put into operation when unemployment rises above 3 percent.

14. With the now acknowledged multiplier effect of a balanced budget in the framework of properly structured taxation and Governmetn programs, there is no need for a budgetary deficit. However, deficit spending cannot be given the major blame for price inflation during the past few years.

15. Yes.

16. Yes; they are required, but of course must be properly related to productivity increases and the general level of prosperity. Similar escalators should be incorporated in annuities, other fixed income securities and payments, and provided in appropriate ways for farm income and the income of other groups whose bargaining power is relatively weak in a generally administered price economy.

17. Causes of present recession:

Falling farm income over a period of 6 years.

Tight-money policy.

Other national economy policies that have favored the relatively strong and injured the weak.

Failure of the Federal Government to appropriate funds and initiate such national priority programs as school construction, teachers' salaries, loans for small business, urban redevelopment, elimination of pockets of chronic depression and underemployment, failure to extend minimum-wage legislation to all groups of workers, minimum wages too low, too slow a rate of power and resources development, and similar policies.

Too heavy an income flow going to the rich and high-income groups with too small an income flow to the poor and low-income group, the result being a failure to clear the market of the goods produced except for a temporary period, then the extravagant use of installment credit.

Resulting overinvestment in capital expansion relative to the growth in consumer income.

The drop in national confidence in our international position.

The vacuum of leadership in the White House which the Senate cannot under our constitutional division of powers fully compensate for; this vacuum of Executive leadership brought on a drop in confidence of both investors and consumers. This, in turn, caused a drop, in Keynesian terms, in both the propensity to consume and the marginal efficiency of capital. Thus, when too late, the tight-money policy was partially reversed, the increased quantity of available money was not sufficiently utilized, even at lower interest rates, to encourage continued expansion at the rate needed to maintain full employment.

What should be done to terminate it:

Enable farmers to earn a parity of income.

Eliminate all excise taxes immediately.

Raise personal income-tax exemptions from $600 to at least $800.

Close all existing loopholes in personal and corporate income taxes.

Require capital gains to be reported as any other income in Federal tax.

Expand, speed up, and initiate fully adequate Federal programs for school construction, increased teacher salaries, improved educational facilities and opportunities, and power and resource development.

Establish margin or price control on such basic key industries as steel, chemicals, and electronics.

Sincerely,

JAMES G. PATTON, *President.*

AMERICAN FARM BUREAU FEDERATION,
Chicago, Ill., March 26, 1958.

Hon. HARRY F. BYRD,
Senate Office Building,
Washington, D. C.

DEAR SENATOR BYRD: I am enclosing the statements of the American Farm Bureau Federation regarding the financial condition of the United States. We have followed the suggested questions which you sent to us on February 17.

As you know, the American Farm Bureau Federation is vitally concerned with the health of our total economy. We have been very much alarmed by some of the recent proposals which would result in the serious inbalance of the Federal budget. Another round of Government-induced inflation would seriously injure farm people.

If there are any areas of question, or if any part of our statement needs further explanation, please do not hesitate to advise us. We appreciate the opportunity to present this statement.

Very truly yours,

CHARLES B. SHUMAN, *President.*

Enclosure.

RESPONSE OF THE AMERICAN FARM BUREAU FEDERATION TO QUESTIONS SUBMITTED BY SENATOR HARRY F. BYRD ON BEHALF OF THE SENATE FINANCE COMMITTEE

1. Give a definition in your own words of deflation and inflation.

Inflation is a condition where the purchasing power of money is reduced by a rise in the general price level. This can be brought about in a number of ways; however, a common cause is Government policies which permit or cause the supply of money and credit to expand more rapidly than the supply of goods. In its more serious stages inflation is characterized by rapid rises in the general price level, stimulated by a lack of confidence in money, a desire to hold tangible assets, and the expectation of further price increases.

Deflation is a severe decline in business activity accompanied by serious unemployment, reduced national income, business stagnation, and a high rate of bankruptcies, all of which are aggravated by a lack of confidence in the economic outlook. This can be brought about by overexpansion and speculative excesses resulting from inflation, or by forces which result in a sharp contraction in the money supply. In a deflation the general price level will tend to decline, but this tendency may be offset to a considerable degree by rigidities in the economy, such as contractual wage rates and administered prices.

2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

The Federal Government has important responsibilities in this matter, because (1) the Constitution provides that Congress shall have the power to coin money and regulate the value thereof, and (2) the Government's financial operations are so large that they cannot help but affect the course of the general price level.

The following extract from the resolutions adopted by the elected voting delegates of member State farm bureaus at our last annual meeting indicates the general policies that we believe to be appropriate to the objective of avoiding inflation and deflation:

"Government policies which affect the supply of money and credit should be directed toward promoting a relatively stable general price level together with high employment and rising productivity. The Government also has a responsibility to so conduct its affairs as to inspire confidence that everything possible is being done to protect the economy from the extremes of inflation and deflation.

"In periods of relatively high employment and business activity, the Federal Government should not only balance its budget and keep it balanced to eliminate the need for deficit financing but also reduce the total national debt. If the budget is unbalanced in such a period, the Government should borrow necessary funds from nonbank lenders to the maximum extent possible to avoid the creation of new money. The existing national debt should be managed to prevent non-bank-held securities from being shifted to the commercial banks, as such a shift creates new money just as the sale of new securities to banks.

"In periods of declining employment and falling prices, these policies can be reversed to combat deflation. In such a period, for example, it may be desirable to reduce taxes to leave more purchasing power in the hands of the public even though this results in a deficit.

"If the budget is to be unbalanced to counteract a deflationary trend, emphasis should be on reduced taxes rather than increased Government spending.

"The Federal Reserve System can help to stabilize the price level by relating its policies to the country's needs for money and credit rather than to other considerations. The independent status of the Federal Reserve Board must be maintained. It should restrain the expansion of bank credit in inflationary periods and make it easier for the banks to extend credit if deflation threatens.

"The policies of Government agencies which make or guarantee loans should be coordinated with overall credit policies.

"In order to be effective in checking deflation, the Federal Reserve System must recognize the danger of a downturn and act before deflation has gone so far that public confidence in the outlook is undermined. In such a situation, prompt tax-rate reductions, especially in the lower income brackets, can be a valuable supplement to Federal Reserve action.

"It is generally recognized that it is more difficult to combat deflation than inflation with monetary and fiscal policies. It should be remembered, however, that our worst deflations have followed periods of inflation and that effective action to prevent inflation will go a long way toward preventing subsequent serious depressions."

Two points in the above quotation from our resolutions deserve special emphasis:

(1) It is highly important that the Government conduct its affairs in such a way as to encourage confidence in the economic

outlook. If people expect either inflation or deflation to occur, they are likely to act in such a way as to contribute to a realization of their expectations.

(2) The most effective means of avoiding deflation is to prevent inflation, because inflation leads to excesses and dislocations which make an economy more vulnerable to deflation.

While our resolutions stress the importance of Government policies to the maintenance of a relative stable price level, we recognize that the policies followed by private groups also affect the stability of the price level. Economic groups which have a degree of power over wages and prices should exercise such powers with restraint and consideration for the general economic situation. For example, we do not think it is sound for unions to demand wage increases or for employers to grant such increases with a view to passing them on in higher prices in a period of declining business and rising unemployment. In our view such action can only intensify a downswing in the economy. Likewise, in a period of high employment and general prosperity, we believe that both unions and employers should consider the inflationary aspect of wage increases that exceed gains in productivity and thereby force prices upward. More importantly, however, we believe that Government policies should be directed toward preventing concentrations of economic power which make it possible for private groups to exercise undue influence over wages and prices. In the business field this means that we must have effective programs to prevent the exercise of monopoly power. In the case of labor it means that unions should be subject to prohibitions against actions to restrain trade comparable to the prohibitions imposed on other groups. It also means that compulsory unionism should be prohibited by law.

The declaration of policy in the Employment Act of 1946 should be amended to remove any implication that the Government has a responsibility, or the capacity, to maintain full employment at all times. The assumption of such a responsibility by the Government can only lead to repeated doses of inflation, and eventual socialism.

3. Comment generally on the monetary control policies of the Federal Reserve System as exercised within the following years: 1942 to 1957. (You may wish to divide the period into two parts, 1942–50 prior to the accord, and 1951–57.)

The policies followed by the Federal Reserve Board prior to the 1951 accord with the Treasury contributed materially to the inflation which took place during this period. The policies followed in financing the extraordinary expenditures of the war period laid the basis for a postwar inflation. As long as the war lasted, however, this inflation was partially suppressed by wartime controls, product deterioration, and a high rate of savings. Since we, as a Nation, were unwilling to pay a substantially larger percentage of the war expenditures through higher taxes, it probably was desirable for the Federal Reserve System to support the Government bond market while the war lasted. In our view, however, it is extremely unfortunate that the wartime policy of pegging the Government bond market was continued for a number of years after the end of the war.

While we do not wish to attempt to evaluate the timing or the wisdom of individual actions taken by the Federal Reserve System since the accord, we are in agreement with what we understand to

be the objective of Federal Reserve policies in the post-accord period. We feel that these policies have made a very great contribution to our economic welfare, by countering inflationary pressures.

4. Beginning in August 1956 there was an increase in the Consumer Price Index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

The period from August 1956 through September 1957 was a period of very high employment and business activity. Consumer demand was at a high level; a boom was underway in the capital goods industries; and private debt was increasing rather sharply. Government spending was also at a high level. Prices were pushed upward by high-level demand and by wage increases which increased production costs in many industries.

Although private demand for goods and services was high, Federal policy must bear a heavy responsibility for the upward movement of prices and wages in this period. Numerous actions to stimulate the economy were taken as a result of the 1953–54 decline in business activity. In some cases these expansive actions undoubtedly had a delayed effect. The high level of Government spending undoubtedly contributed to an inflation psychology which in turn increased the public's willingness to spend. Government action in increasing the minimum wage of 75 cents to $1 per hour in March 1956 established a basis for wide-spread wage demands to restore historic differentials for skilled workers. The high level of business activity helped many unions to obtain wage increases, which were soon translated into higher prices.

The continuation of Government spending at a high level in the face of a high level of private demand contributed to higher prices even though the budget was balanced. Under the circumstances, the Government could have made a real contribution to price stability by reducing its expenditures and increasing payments on the national debt.

5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

The current public debt carries with it a built-in potential for future inflation. If debt management were to permit the shift of privately held Government bonds to the commercial banks or a shift of bank-held bonds to the Federal Reserve banks, the result would be an expansion of the money supply. When the money supply is allowed to expand more rapidly than the production of goods, an inflationary pressure is created.

On the other hand, policies which shifted the bond holdings of Reserve banks or commercial banks to private investors would contract the money supply and exert a deflationary pressure on the economy. It is an important task of debt management to handle the debt in such a way as to contribute to the stability of the price level and to an expanding economy. This means that debt management must take account of the economic situation. In recent years the task of doing this has been complicated by the large volume of debt coming due each year.

6. (*a*) Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy in the United States:

1. Price stability.
2. Stability of production, demand, and employment.
3. Economic growth in production, demand, and employment.

(*b*) With respect to these three objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially during 1957.

(*a*) The most important of these objectives is "economic growth in production, demand, and employment." Taken literally, objective No. 2 seems to us to be undesirable. Stability in production, demand, and employment would mean stagnation. We must have economic growth if we are to improve our living standards, or even to maintain present standards for a growing population.

We assume that objective No. 1 is intended to refer to stability of the general price level which means stability in the purchasing power of money rather than stability in individual prices. Individual prices must fluctuate in order for a free choice, or market, economy to work. Price-level stability is desirable as a means of creating a favorable climate for continuing economic growth, and to avoid the hardships that inflation and deflation impose on various groups. Economic growth in production demand and employment can continue for a time despite inflation, but inflation leads to excesses and imbalances which set the stage for an eventual crash.

(*b*) With relatively short interruptions we have had a fairly rapid economic growth in production, demand, and employment throughout the postwar period. Prices rose sharply in the early postwar years when the removal of price, wage and allocation controls released the inflationary forces which had been suppressed during the war. In this period and in the early months of the Korean incident the Federal Reserve policy of pegging the Government bond market added materially to the inflationary pressures. The first postwar recession or adjustment was shortened by the outbreak of fighting in Korea. The inflationary rise in prices which occurred in the early months of Korea was so clearly aided by Federal Reserve policy, that it paved the way for the accord of 1951. After the accord the price level dropped slightly and then moved sidewise in a remarkable demonstration of stability for approximately 4 years. In this period, however, upward movements in nonfarm prices were offset by declines in farm prices. Considering the fact that the decline in farm prices was due to some rather special circumstances it would appear that there was some inflation in nonfarm sectors of the economy during this period despite the relative stability of the general price level. Beginning in mid-1955 prices began to move upward for reasons which have been discussed under question No. 4.

The most significant trends of the postwar period have been (1) the rise in prices which took place when suppressed wartime inflation was allowed to manifest itself; (2) the further inflation that was allowed to take place under the policy of pegging Government bond prices, (3) the relative stability in the general price level which existed

for almost 4 years after the 1951 accord, (4) the renewal of inflationary pressures in 1955, and (5) the current downswing in business activity.

7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

In our opinion the overall level of current Federal, State, and local government spending is too high in relation to national income. The current high level of Government spending tends to be inflationary although this inflationary tendency may be temporarily offset at times by readjustments in the private sector of the economy. While we believe that it would be desirable to reduce the percentage of our total income that is spent by Government, we also favor a redistribution of responsibilities which would tend to reduce the Federal share and increase the State and local shares of total governmental spending.

8. Give your opinion of the effect on our economy of current Federal, State, and local taxation.

The present high level of taxation undoubtedly has an inhibiting effect on economic growth. This is particularly true in the case of Federal income taxes. The present level of Federal income taxes makes it more difficult for the private economy to accumulate capital for economic growth and reserves for bad times. Another important consideration is the fact that the present high level of Federal income taxes leads to a continuing pressure for special treatment of various situations. Special tax concessions erode the income-tax base, force the maintenance of high rates, and put a premium on ability to arrange personal and business affairs in such a way as to take advantage of exceptions to the basic law. Thus, tax considerations have become a big factor in many business and personal decisions.

The continued heavy dependence of many local and some State governments on property taxes discriminates against taxpayers such as farmers, the railroads, and others who necessarily have a high investment in real property.

9. Will you distinguish between fiscal policy (embracing expenditures, taxes and debt) and monetary and credit policy, and then relate them, one to the other. Please discuss these policies stating how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

Fiscal policy and monetary and credit policy both affect the supply of money and credit available to the economy and consequently the price level. As is pointed out in the question, fiscal policy involves government expenditures, taxes and debt. Monetary and credit policy relates to activities which influence the total volume of money and credit in the economy through such things as reserve requirements, discount rates, and the open market operations of the Federal Reserve System. Both fiscal policy and monetary and credit policy can either be inflationary or deflationary. The effect of an inflationary or deflationary action in the fiscal field can be offset by opposing action, or intensified by supporting action, in the monetary and credit field. A general outline of how monetary and credit and fiscal policies can be used to promote price level stability is set forth in the extract from our resolutions which was quoted in answer to question No. 2 above.

10. (*a*) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purpose of this question consider that the monetary system includes bank deposits and bank

credits). Also please furnish your ideas for the correction of any inadequacies that you feel now exist in our monetary system.

(*b*) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

(*a*) In general terms we believe that the United States has an adequate monetary system. The chief deficiency in our monetary system is the fact that it requires the Federal Reserve System to make numerous decisions with regard to the timing, direction, and magnitude of various actions. All human judgments are subject to error and it is often difficult for Reserve authorities to determine exactly what is happening in the economy at a particular moment. This is a problem which deserves continuing study; however, we do not have any recommendations with respect to it at this time.

(*b*) There are two basic inadequacies in the United States fiscal system: (1) The public pressures on Congress for increased expenditures are intense and specific while the pressures for economy are general and diffuse. As a result it generally is easier for the Government to increase expenditures than to reduce them. The only solution to this problem is for the groups that are interested in economy to do a better job of creating understanding of the need for restraining Federal expenditures and for Members of Congress and the administration to exercise their leadership on behalf of governmental economy. The base of the Federal income tax should be kept broad through the retention of reasonably low exemptions as a means of reminding all self-supporting individuals that Federal services are not costless.

(2) Congress has, to a considerable degree, lost control of the Federal budget. There are many expenditures which Congress cannot affect except by enacting changes in basic legislative authority. The fact that an expenditure is authorized by law is often taken as a primary justification for continuing it. Public pressures on Congress encourage greater attention to proposals for new programs than to a review of programs that perhaps should be reduced or eliminated. The existence of large accrued balances from previous appropriations makes it difficult for Congress to affect the amount that may be spent in any particular fiscal year. Finally, present legislative procedure results in the consideration of individual spending proposals with very little regard to the overall budget picture.

We have no simple panacea for the correction of these deficiencies. We believe that it would be helpful, however, if the legislative committees of Congress would spend more time on periodic reviews of existing programs with a view to eliminating or reducing programs whenever changing conditions justify such action. We also believe that it would be helpful if the Congress would develop some workable procedure for deciding affirmatively whether the Federal Government shall run a deficit or surplus in any fiscal year and the approximate amount of any such surplus or deficit. One approach might be to require that the Congress reconcile its actions in the fiscal field before adjournment each year (A) by specifying the amount that is to be paid on the public debt or the amount, if any, of deficit that is to be incurred and (B) by adjusting taxes and appropriations to harmonize with the overall target for a Federal surplus, deficit, or balanced budget. We, of course, realize that it may not be practical

to control expenditures and receipts with the precision necessary to hit an exact target set by the Congress. The point, however, is that the Congress should affirmatively assume more responsibility for deciding whether the goal of current fiscal policy is a balanced budget, a deficit, or a surplus; and the general magnitude of any such deficit or surplus.

11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy.

(*b*) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

(*a*) A certain amount of what may be called frictional unemployment is to be expected even in a period of strong inflationary pressures. Individuals may become unemployed for a number of reasons, and in a free economy there frequently will be a need for readjustments which will produce unemployment in particular industries even in periods of inflation. The need for such readjustments can arise from overexpansion when demand is high, or from such factors as changing demand patterns, competition, and technological developments.

The seeming paradox of continuing inflation and rising unemployment may develop on a broader scale as a result of rigidities in our economy which cause prices and wages to remain steady or to rise when business is declining.

(*b*) No. Even a gradual inflation would work a hardship on many people and make the economy more vulnerable to serious depressions. A price rise of only 2 percent per year would cut the real value of the dollar in half every 35 years.

If people at large became convinced that it was the policy of the Government to foster a gradual inflation, they would be encouraged to act in such a way as to cause the inflation to proceed at a more rapid rate and this would increase the danger of an eventual crash.

12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy.

Private debt may reflect a transfer of savings, or the creation of new money through the expansion of bank loans. Anything that causes the supply of money to increase more rapidly than the supply of goods and services tends to be inflationary. When production and prices are pushed to a high level through the heavy use of credit, there is danger that a downswing will be intensified not only by a reduction in credit purchases but also by a reduction in the cash purchases of debtors who may seek to accelerated repayments in the face of uncertainty. The danger of widespread defaults on private debt is reduced by the fact that most private debts carry provisions for systematic repayments. Private debt currently is at a high level in terms of dollars; but it is not necessarily excessive when account is taken of our present population, and such factors as the value of the dollar, private assets, and national income. The extent to which private debt is a threat to stability largely depends on whether or not we can use available fiscal and monetary tools in such a way as to avoid unstabilizing effects. For example, when private debt is growing it may be desirable to reduce the Federal debt or to take other offsetting action. If we allow a serious deflation to develop,

the present level of private debt probably would operate to intensify our difficulties.

13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy.

We do not believe that it is practical or desirable to determine in advance a fixed set of conditions which would justify major Federal action to cut taxes or inaugurate large increases in public works. The question of when such action should be taken is a matter of judgment. The decision should be based on economic trends and prospects rather than the immediate situation. In other words a situation that would not call for major Government action when the economic outlook appears likely to improve in the near future might justify major Federal action at another time when the economy seems to be in a downward spiral which is undermining public confidence. In cases where major Federal action appears to be indicated we prefer tax reduction to large increases in public works. While we believe that it is desirable to accelerate the construction of sound, well-planned public works that would be undertaken anyway in the normal course of time, when there is a slack in the civilian economy, we do not believe that a downturn in business activities should be used as an excuse for make-work projects or other public works which are unsound from an economic standpoint. Tax reduction can be put into effect much more rapidly; and terminated more promptly than a public works program; it is more in keeping with a free choice system; and we believe that it would be more effective than pump priming.

14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

The real basis for our postwar inflation was laid during the war when truly enormous deficits were financed to a large degree by selling bonds to the commercial banks. While postwar deficits have contributed to inflation, this contribution has not been a major factor in comparison with the rise in the public debt which took place during the war years. Other important factors in the postwar inflation have been (1) pentup consumer demand, (2) the continuing high level of Federal expenditures, and (3) the policies followed by the Federal Reserve System in pegging the Government bond market prior to the Federal Reserve-Treasury accord of 1951.

15. Can full employment goals be attained while maintaining a dollar that has relatively stable purchasing power?

No. In our opinion efforts to maintain full employment on a continuous basis will lead to inflation which ultimately will result in a crash and serious unemployment. A relatively stable purchasing power can be maintained only by letting natural forces in the economy operate to bring about the adjustments which inevitably are needed from time to time. On occasion some of these adjustments will result in temporary increases in unemployment.

16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

No. The basic idea of adjusting prices and wages on the basis of a formula is fallacious. In our opinion it is impossible to devise a formula that will tell you exactly what adjustments should be made in prices or wages in any given time. In a period of rising prices escalator clauses have an inflationary effect. If widely used, such clauses can produce a spiraling effect.

One effect of using the cost of living index as a basis for wage adjustments is to make it possible for temporary prices in one sector of the economy to cause wage increases, and consequently, price increases in other sectors. For example, the food prices that go into the cost of living index are not adjusted for seasonal variation. Under certain conditions, a seasonal increase in food prices may result in wage increases. Such wage increases contribute to price rises which tend to prevent a reduction in the cost of living index when food prices decline seasonally. In recent weeks we have seen an increase in the cost of living—which was brought about, in part, by frost damage to the Florida vegetable and citrus crops—result in wage increases at a time when unemployment was rising. It seems to us to be completely indefensible to allow an increase in food prices resulting from seasonal influences or a temporary situation, such as a freeze, to force an upward adjustment in wages. Such a development is particularly unfortunate when unemployment is increasing.

The use of the cost of living index as a guide to wage adjustments is also made inappropriate by the fact that it is impossible to take adequate account of such things as changes in quality and variations in trade-in allowances in the determination of a statistical price index. The undersirability of escalator clauses from an economic standpoint is further emphasized by the fact that there is little evidence that unions would be willing to accept any substantial reduction in wages if the cost of living index were to decline substantially. On the contrary, there has been a tendency for unions to insist that increases made on the basis of increases in the cost of living be incorporated into the basic wage structure in subsequent union-management agreements.

17. List and briefly discuss what you consider the causes of the present recession, and what should be done to terminate it.

It is unreasonable to expect a free choice, market economy to move upward at all times. When business is good and profits are rising, production is stimulated with the inevitable result that some industries oversupply the market. Our economy has been moving upward with relatively minor interruptions ever since the end of World War II. In recent months the capital goods boom, previously referred to, has resulted in a great expansion of productive capacity. At the same time that productive capacity has been increasing, prices have been rising in response to rising wages and other costs. Under these circumstances it is not surprising that we have run into a period of readjustment.

The basic things that we need to do to terminate the recession are (1) to avoid rushing into unsound programs which could set the stage for a serious inflation later, and (2) to allow some time for economic forces to work out adjustments and set the forces of recovery in motion.

We see no justification for a major expansion of public works. It is not yet clear that a reduction in income taxes would be warranted

at the expense of a large Federal deficit. It would, however, be desirable to explore the possibilities of reducing Federal spending and simultaneously making a corresponding reduction in Federal taxes.

One of the things that is needed under present conditions is action to encourage increased consumer and business spending. To this end it would be most helpful if business and labor would cooperate in programs to reduce costs and prices.

CHAMBER OF COMMERCE OF THE UNITED STATES,
Washington, D. C., April 28, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR HARRY: I am pleased to attach a statement of the chamber's views pertaining to the questions you sent us in connection with your investigation of the financial condition of the United States. This reply has been prepared jointly by our economic research and taxation and finance departments.

I certainly agree with you as to the necessity of our maintaining a strong and sound economy. I congratulate you and the Finance Committee upon the study you are making.

Cordially yours,

PHILIP M. TALBOTT, *President.*

Attachment.

STATEMENT OF THE CHAMBER OF COMMERCE OF THE UNITED STATES ON THE FINANCIAL CONDITION OF THE UNITED STATES, SUBMITTED TO THE SENATE FINANCE COMMITTEE IN RESPONSE TO THE QUESTIONS POSED BY THE CHAIRMAN ON FEBRUARY 17, 1958

Question 1. Give a definition in your own words of deflation and inflation.

There are no hard and fast definitions of these terms; they are used in different ways by different people and by the same people for different problems or purposes.

Definitions, of course, are necessary and useful to keep discussions on the same grounds and to aid logical analysis, but they do not in themselves convey truth as to cause and effect relationships. Just as every "sale" is also a "purchase," so inflation or deflation can be defined from different points of view.

For purposes of public policy it would seem sensible to define inflation and deflation as complex economic processes by which the general level (average) of prices is raised or lowered causing a reciprocal reduction or increase in the purchasing power (value) of the monetary unit as a generalized medium of exchange and store of value.

Inflation, looked at this way, is a flow of money spending in excess of the current supply of goods and services valued at stable prices. The result is a rising average price level. This could occur:

(*a*) When total spending was stable and physical output shrinking;

(*b*) When both output and money spending were shrinking but with output declining at the more rapid rate;

(*c*) When money spending increases more rapidly than output.

Deflation occurs when the flow of money spending is insufficient to absorb the current supply of goods and services at stable prices. The

general price level, therefore, falls. As with inflation, deflation can occur under different sets of circumstances—whenever the flow of money spending falls faster or rises more slowly than the flow of real goods and services coming to the market place. Sometimes inflation is identified with prosperity and boom, and deflation with a decline in business activity or employment. But such terminology may be confusing, since rising prices may be associated with either "overfull" employment or underemployment. The same is true for falling prices.

These statements in themselves still do not reveal the causes of why disproportionate changes occur in the rates of money spending and the flow of goods and services.

Inflation and deflation, as with all economic events, are compounded out of interaction of several causes. The crucial variables are: (1) the supply of money; (2) the desire of the public for more or less liquidity and their preferences as to the composition of their assets; (3) how costs of production are determined; and (4) how output responds to changing cost and demand conditions.

In the process by which the general level of costs and prices move up or down, incomes are a vital link. The national payroll is, in a sense, the conductor of inflation. Some definitions focus attention on income-price relationships. From this point of view inflation occurs when, as a Nation, we pay ourselves more dollars without producing more real product. Real output is then rationed out by higher prices.

All these definitions, of course, greatly oversimplify the problems. The processes of inflation and deflation are too complex in modern economic life to be clearly defined or described in a few short and simple sentences.

Question 2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are requires, then make specific suggestions.

The economy of the United States cannot avoid either inflation or deflation completely. In a free economy characterized by diffused decision making and continuous dynamic change, the course of economic progress can never be completely smooth and painless. A great strength of a free economy is its ability to adapt to changing demands, technological innovation, population shifts, and altered conditions in supplies of basic resources. Some fluctuation in the price level, and other economic variables such as output and employment, is inevitable, necessary and desirable.

What we want to avoid is the violent swings which go beyond the range of normal economic adjustment—mass unemployment on one hand and persistent inflation on the other. In other words we seek orderly growth with relatively stable prices.

To achieve this goal in ways which will foster and preserve free competitive enterprise is no easy task. Fundamentally, it depends on the values of the public and whether we can muster the political courage to face the issues.

To avoid inflation we must:

(*a*) Vigorously apply monetary restraints in periods of boom when total demand is straining against the limits of physical capacity.

(*b*) Vigorously apply fiscal retraints during a boom to prevent overloading the economy with demands that cannot be fulfilled. This requires substantial budget surplus which can be achieved only by restraints on Government spending and a tax level and structure which will provide the necessary revenues without depressing healthy productive activity at the same time.

(*c*) Vigorously promote competition in all markets for goods and labor services. Unless monetary and fiscal policies are applied to a competitive market structure, inflationary pressures cannot be kept in check without enormous costs of unemployment and other economic maladjustments. Monopolistic wage determination and other wage-cost-price rigidities are probably the greatest barrier to adequate control of long-run inflationary movements.

(*d*) Deliberately shun, during a business contraction, unwise anti-recessionary policies which create massive inflationary pressures after the slump has passed. Massive spending programs, for example, which come to fruition after recovery has set in and become long-run Government programs competing with other demands on the economy, not only do not help in recession, but they create greater instability by accentuating the upswing during a boom.

To avoid deflation, policies consistent with those above are required. It should be pointed out again, however, that "deflation" in the sense of falling prices is not synonymous with "recession." Nor is "inflation" in the sense of rising prices the same as "prosperity."

Fluctuations in the level of economic activity manifest themselves in 2 ways—or a combination of 2 ways: (*a*) in price-income cycles and (*b*) in output-income cycles.

In the first case money incomes fall because prices fall; the output, employment and real incomes remain fairly stable. In the latter case money incomes fall because output and employment fall with prices remaining fairly stable. Adjustments through prices are much to be preferred from a welfare standpoint, because society does not lose the real income as it does when adjustments are made via changes in output and employment.

There is grave danger that we "outlawed" deflation in the sense of downward price adjustments by developing a market structure shot through with wage-cost rigidities. If this is true, prices are flexible upward but not flexible downward, and we will have a built-in systematic inflationary bias over the long run. We will still have recessions, but mainly in the form of falling sales, output, and employment.

To prevent both price inflation and price deflation, as well as overfull employment and recession, the system must be kept as flexible and competitive as possible, and both antirecession and antiinflation policies must be consistent so as to eliminate systematic biases arising both out of the structure of the economy and public policies.

If we are to avoid major inflations and deflations, it should be a matter of declared public policy that we aim to do so. For this reason, the Employment Act of 1946 should be amended to espouse explicitly reasonable stability of the general price level as a policy goal.

Question 3. Comment generally on the monetary control policies of the Federal Reserve System as exercised within the following years: 1942 to 1957. (You may wish to divide the period into two parts, 1942–50 prior to the accord, and 1951–57.)

The Federal Reserve policy, starting in 1942 with the war, was primarily aimed at providing money which the Treasury Department could use to meet Government expenditures. Between 1940 and 1946, the Federal Government spent more than $383 billion—with the help of large-scale action on the part of the Federal Reserve System. During this period, the Treasury borrowed approximately $200 billion. The Federal Reserve System and commercial banks supported the Treasury by increasing their holdings of Government securities by approximately $90 billion.

Beginning in 1942, in March, the Federal Reserve System committed itself to see that the Treasury Department was supplied with all the credit necessary to finance a war and further, that the level of interest rates on Government securities would not be allowed to rise during the war.

During this period, the Federal Reserve System subordinated normal monetary functions to war finance. As a result there was very little effective restraint on the expansion of the supply of credit or money. Selective credit controls enacted by Congress and moral persuasion were used by the Reserve System in an effort to hold down private borrowing. In addition, price controls helped to suppress, at least temporarily, some of the inflationary effects of wartime financial policies. But inadequate tax collections, the great increase in Government expenditures, price controls and rationing had delayed effects. The increases in personal income resulted in an abnormal rate of personal savings; consumer credit did not increase in the usual proportion; business firms accumulated large amounts of savings. When World War II ended, businesses and people of the country were holding tremendous amounts of liquid assets. From 1940 to 1945, personal savings amounted to nearly $137 billion and gross business savings, $74 billion. This was an explosive inflationary setting.

When the war ended, the Federal Reserve System seemed to have two choices: to continue support of Government bond prices without regard to economic conditions, or to use monetary policies to curb inflation. The Treasury Department and the Council of Economic Advisers defended the position that easy-money policies of World War II should be continued. They felt that increased interest rates on the national debt would add greatly to the problem of refinancing and cost of debt maintenance; that refunding would be a very serious problem; further, that to permit Government bond prices to decline would set off a monetary panic and destroy faith in Government credit and that the proposed restrictive policies would not be effective against inflation.

Those who advocated continuing easy-money policies had two major objectives: to hold down interest charges on the national debt; to facilitate Treasury refunding and to stabilize the prices of Government bonds—and, incidentally keep rates low for borrowers. Others felt that we should follow the traditional policy of restricting credit and money in order to hold down inflation, and that we should allow the interest rates on Government securities to advance at least to the point where credit restraint would be effective; that there were adequate weapons available to prevent panic in the bond market or disruptive monetary effects; and that the Federal Reserve Board should buy only sufficient Government's to keep the market "orderly."

It is quite evident that in the 1946–47 period the Federal Reserve faced the dilemma of dual responsibility—economic stability and Treasury debt management. Its actions indicate that it was convinced that the public debt was of such magnitude and importance that it should take preference over antiinflationary policies and restrictive measures should be used only when they did not interfere with the support of the Government securities market.

The Douglas committee and its investigations found this to be the case. In 1948, the bond-support policy became a very clear-cut issue as the Federal Reserve System's holding rose $11 billion during 1 year. During this period the impossibility of restraining credit and currency expansion, while at the same time supporting Government bonds at par was clearly demonstrated.

In 1949, during the mild recession, the Federal Reserve Board took action to ease credit by lowering reserve requirements for member banks. At the same time, however, the Federal Reserve System was trying to maintain a fixed low rate pattern of interest rates on different kinds of Government securities. To do this it actually sold Government securities, thus tightening credit one way while loosening it in another. Here again the conflict between Treasury debt management and appropriate monetary policy was clearly apparent.

With the Korean war in the summer of 1950 and the reversal of our economic situation, the Federal Reserve raised discount rates in an effort to curb inflationary trends. Installment credit controls were also enacted under the Defense Production Act of 1950. Again the conflict ensued. When Treasury notes were put up for sale, the Federal Reserve had to buy large amounts which more than offset other antiinflationary measures.

In March 1951, when the famous Treasury-Federal Reserve accord was reached, it was decided that the Federal Reserve System would no longer peg the prices (and interest rates) of Government securities. Instead it was to return to serving its primary function of directing national monetary-credit policies to meet changing economic conditions. Within such a framework, however, it was agreed that the Federal Reserve would help to maintain an orderly market for Government securities. Following the accord, the antiinflationary measures taken by the Federal Reserve helped to keep the Korean war inflation fairly well in check—although much of the damage had already been done.

During the 1953–54 recession the system demonstrated its flexibility by substantial easing of credit conditions. In fact, Federal Reserve officials have subsequently stated that it is possible that they eased credit too much too fast and thereby overstimulated the economy in 1955 which contributed to the boom and inflation of 1956–57.

In 1958, in face of a business contraction, the Federal Reserve has taken a series of steps to ease credit and reduce interest rates. Many feel that the tight-money policy of last year was not reversed quickly enough at the first signs of the downturn. But with prices still rising, uncertainty and the dangers of overstimulation, the early caution of Federal Reserve officials is understandable.

In conclusion several points should be made:

(1) Clearly national monetary policy cannot and should not be subservient to managing the Government debt. To make it so would

lead to the bankruptcy of inflation and throw a most important tool of countercyclical economic policy out of the window. For several years from 1946 to 1951 the Employment Act was, as a practical matter, a one-sided ineffectual statement because monetary policy was hamstrung in order to make the Treasury's lot more comfortable.

(2) Since 1951 Federal Reserve actions have generally been in the right direction. There will always be disagreement as to whether monetary measures are too early or too late, too forceful or too timid, but such criticisms should not be allowed to undermine the vital functions which the System must perform. In general, Federal Reserve officials are to be commended for the manner in which they have pursued their duties, unruffled by the pressures they receive from all sides.

(3) Since the accord, the Federal Reserve System has confined its open market operations to the short-term Government securities market. The so-called "bills only" doctrine is still a matter of considerable debate among economists and in financial circles. Federal Reserve officials argue cogently for their position of influencing the market rather than "making the market." In general we believe this position is sound, as long as open market operations are not made the principal instrument of credit policy, but are used in conjunction with other policies which shorten the time lag between monetary action and the final effects on terms of credit in the market.

(4) We endorse the general position of the Federal Reserve Board in holding that general, indirect monetary controls are the appropriate means of restraining inflationary and deflationary movements in the money market. Direct controls, except for regulation of stock market credit and providing minimum standards for prudent commercial bank operations, are not consistent with a free market system. Selective controls over terms of particular kinds of credit—for example, consumer installment credit—are administratively not feasible and are inimical to freedom of consumer choice and efficient resource allocation. It is sometimes argued that general monetary policy discriminates unfairly against certain classes of borrowers. No doubt this is, in part, true. But it is hard to imagine a more arbitrary and discriminatory method of credit rationing than to replace general monetary policy by direct controls and rationing by Government fiat. The solution to market imperfections is to improve the flexibility and competitiveness of the market mechanism, rather than sabotaging the machinery by direct Government intervention.

Question 4. Beginning in August 1956 there was an increase in the Consumer Price Index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

The Consumer Price Index started to climb in 1956 and is still moving upward. The various factors contributing to the increase in the index did not operate throughout the whole period with the same strength, but the combination of factors and their interaction has been sufficient to keep the upward trend going, albeit with some loss of momentum from September 1957 to the present. Briefly the chief factors were these:

(*a*) A major investment boom starting in 1955 and reaching its peak in 1957. Contributing to the rapid acceleration of business investment was the bouyant consumer demand in 1955, the tax cut of

1954, and antirecessionary easy monetary policy followed in 1953 and during most of 1954.

(*b*) Expanding Government expenditures during this period. From 1950 through 1957, Government purchases of goods and services (Federal, State, and local) increased from $76.6 billion in calendar year 1954 to $86.6 billion in calendar 1957. Even though the Federal administratitive and cash budgets showed a surplus in the fiscal years 1956 and 1957, the rising Government demand contributed to the pressure on resources and prices.

(*c*) An intractible wage-cost push situation. Wages in manufacturing are a case in point. From January 1956 to December 1957 average gross hourly earnings in manufacturing increased from $1.93 per hour to $2.11 per hour—an increase of almost 10 percent. Output per man-hour in manufacturing increased less than 2 percent during this period. The inescapable result was a period of substantially rising unit labor costs. When money wage rates are rising over broad sectors of the economy well in excess of productivity improvements, some part of the higher per unit costs must come out of higher prices.

In summary, 1956–57 was a period of economic overload. On top of a big investment boom were growing demands for defense and other governmental services at all levels of Government. In addition, people were demanding more goods and services for private consumption, and at the same time labor was demanding wage increases far larger than existing prices and productivity could support.

Question 5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

As a complementary tool of countercyclical financial policy, debt management now has great importance because of the present size of the Federal debt and because of the special role such debt plays in the asset structure of financial institutions. The Federal debt now amounts to about two-fifths of the economy's total debt. It is the only debt that is entirely free from credit risk. Short-term Federal debt serves as a principal liquid or operating reserve asset of banks, other financial institutions and business corporations. Longer-term Federal debt functions as a major investment asset of individuals and savings institutions and competes with other investment mediums in absorbing the economy's money savings. The types of Government securities issued thus have a significant effect on the liquidity of the entire economy and on the market for other securities.

Debt management has two major aspects. It involves refunding operations affecting the maturity arrangement of outstanding debt. It also involves the expansion or retirement of debt in response to the current cash deficit or surplus of the Government. The maturity composition of the debt has its most direct tie with credit and monetary policy while the changes in the amount of debt are most immediately related to fiscal policy. Both aspects combine to determine the composition of the total Government debt at any given time and together exert a significant influence on economic balance.

Management of the Federal debt makes a primary contribution to economic stability by arranging a maturity composition of that debt that will support and not impede development of appropriate credit and montetary policy. In general, such a debt distribution would be

one with maturities well spaced over a period of years. This kind of maturity distribution is also important for administrative reasons in debt management.

There is, of course, constant need for a large volume of short-terms issues to meet the basic liquidity requirements of banks, financial institutions, business corporations, and others. In a period of economic slack or depression this liquidity may be expanded by issuing additional short-term obligations. In the subsequent period of expansion the volume of these issues may be reduced somewhat by refunding operations or by retirements out of surplus.

To change the existing debt structure, however, takes time. Financing decisions of the past necessarily impinge heavily on the present and the future, and debt management actions must continually be a compromise between what may be most appropriate for the current economic situation and what may be appropriate in terms of a longer run view of economic stability. This balance in judgment relates primarily to the volume of very short-term securities which may be outstanding at any time. Because the liquidity of such securities is not readily influenced by credit and monetary measures, the greater the proportion of the debt in these issues the less responsive the economy will tend to be to restrictive credit and monetary action when such measures may be appropriate.

From the point of view of economic stability, the maturity distribution of outstanding debt should always be such that moderate changes in the level of interest rates will have an important effect on the liquidity positions of holders, thereby influencing spending and lending decisions. To attain this, a sizable portion of the debt should be spread out over intermediate and long-term maturities so that when interest rates decline, and the market prices of these securities therefore rise, liquidity positions of holders will come to be regarded as more adequate than formerly. Conversely, when interest rates rise and security prices decline, holders will tend to view these positions as less adequate. Such a spread maturity distribution would limit the dependency of debt management on current interest rates and security market conditions and, on the other hand, would increase the sensitivity of the entire economy to interest rate changes.

Within the standards set for debt balance, current debt management can operate to reinforce or offset in part the impact of a Federal deficit or surplus. For example, a deficit in a recession period may be made somewhat more effective if in its financing the emphasis is placed on the use of shorter-term obligations. The expansive effects will tend to be greater and will support an expansionary credit and monetary policy to the extent that such issues are absorbed by the banking system and foster expansion in the money supply. Conversely, a surplus in a boom period will be more effective as a restraint on expenditures if it is used to retire short-term debt rather than to purchase long-term securities in the market. The restraining effects will tend to be increased and will reinforce restrictive credit and monetary policy if the repayment of debt reaches the holdings of short-term issues by the banking system, thus affecting bank liquidity positions.

Debt management actions to promote economic stability through shifts in terms and maturities of security offerings are limited by the necessity of meeting existing market conditions. Public debt must be handled so that the investing community will be receptive to new

issues from refunding operations and will take additional debt into its portfolio. While public debt differs from private debt instruments in quality, public debt instruments compete with similar securities of private origin in the market. In short, the debt must be in such form that it is readily assimilated in the market.

There are other practical problems of debt management to be resolved. Recently, acceleration of corporate tax payments has resulted in a concentration of Treasury receipts in the first half of the year while Government outlays are more evenly distributed. This necessitates a seasonal pattern of short-term borrowing and repayment of borrowing even if the cash budget is in annual balance.

Debt management must develop its policies and feel its way not only in response to immediate Treasury needs, to investor preferences, but also with regard to the cost of servicing the debt. From both the standpoint of interest cost and economic stability there are many alternative arrangements of a given debt. Problems of current interest cost must be weighed against the costs to the Federal budget and the economy in general if debt management decisions are excessively inflationary or deflationary. They must also we weighed against possible future interest costs under different economic circumstances. Debt management decisions thus must consider both the present and future, as well as the implications of action on the effectiveness of other instruments for achieving economic stability.

Question 6 (a). Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy in the United States:

1. Price stability.
2. Stability of production, demand, and employment.
3. Economic growth in production, demand, and employment.

There is no doubt that the Nation faces a "trilemma" of trying to achieve three partially incompatible goals at the same time: price stability, high employment and output, and economic growth.

While these goals are partially incompatible, they are also, in part, mutually interdependent. Sustained economic progress depends on the avoidance of major booms and busts. Lapses from high employment levels will be shorter and less severe if the maladjustments of inflationary surges are kept to a minimum. At the same time, however, if we try to achieve too high a rate of economic growth and set unrealistic continuous full employment goals, chronic or sporadic inflation will eventually force a conscious choice among the three objectives.

If conscious choices must be made among the three goals, most people rank them in the following order:

(*a*) Fairly high levels of employment.
(*b*) A reasonable degree of stability in the general level of prices.
(*c*) High rates of economic growth.

With mass unemployment the whole economy suffers the loss of real income in addition to the penalties visited upon particular individuals. Inflation on the other hand is a cruel and capricious tax on individuals, and on society generally if it precipitates, as it is likely to do, periodic contractions in output and employment.

While a high rate of economic growth is desirable for several reasons—e. g., rising levels of living and defense capacities—there is nothing sacred about any particular rate of growth. Ultimately the

rate of economic progress depends on several factors. Among the more important are:

(*a*) The choices people make in the market place—how much current output in real terms they collectively indicate they wish to devote to capital formation rather than current consumption.

(*b*) Public and private investment in skills and education which upgrades the quality and productivity of the labor force.

(*c*) How rapid an exploitation and application of new technological development takes place.

(*d*) The total business climate which either encourages or discourages risk-taking investment and managerial efficiency. Obviously, the kind of tax system we have is an important factor in setting either a favorable or unfavorable growth climate.

High pressure growth financed by inflation is dangerous because it is chaotic growth which chokes itself off and creates disorder in the system. Inflation is an uneven process. Some prices and incomes rise rapidly and others are sticky or lag behind. Investment plans and ordinary business decisions, difficult at best, cannot be made on a rational basis. The whole structure of production, prices, and incomes becomes distorted, creating maladjustments which must be painfully corrected through the catharsis of recession or depression. In short, a sustained and sustainable rate of growth requires that we avoid both extremes of overemployment and underemployment.

Though the three goals as we have seen are closely interrelated, they are difficult to achieve simultaneously. Especially, it will be difficult in the foreseeable future to reconcile demands for continuous high employment and general price stability. This is so for a number of reasons:

(1) In periods of economic growth, change, and rapid technological advance, the economy has a low inflationary threshold because of short-run immobilities of resources, bottlenecks, and wage-cost rigidities. Under such conditions price increases may manifest themselves at a point below a "politically tolerable" level of employment.

(2) Strong labor monopolies make full use of the bargaining powers conferred on them by the "maximum empoyment" commitment of the Federal Government and the legal immunities inherited from the past which they enjoy. As a result, wage rates and costs go up year after year, and never come down. Until action is taken to correct the fundamental noncompetitive elements in the market structure to which anti-inflationary monetary and fiscal policies are applied, high employment will be bought at the high price of chronic or recurring inflation.

(3) Monetary and fiscal policies as now conceived and applied have a serious inflationary bias. Monetary policy to curb inflation evokes loud cries of pain and anguish, and during recession spending schemes are set in motion which result in a systematic expansion of inflationary government spending converging during boom periods. Unfortunately, there appears to be political preoccupation with one goal—full employment. As long as this preoccupation persists, policy may be expected to err on the inflationary side.

Question 6. (*b*) With respect to these three objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially during 1957.

Clearly, since World War II, "full employment" has taken precedence over the other goals of public policies. In the immediate postwar period some open inflation was inevitable as a result of the methods used to finance the war and to suppress their price effects by direct controls.

The great increase in the money supply produced by war deficits and the very liquid state of business and individuals provided ample inflationary fuel for an excess in money demand. To complicate matters, as has been pointed out previously, debt management policy and monetary policy were directed at keeping interest rates and charges on the Federal debt as low as possible rather than holding inflation in check. It was not until the Treasury-Federal Reserve accord was reached in 1951 that any serious attention was given to the problem of inflation. It is indicative of postwar public and political attitudes that reasonable price stability was not made an explicit policy goal in the Employment Act of 1946.

In the past 2 or 3 years, the importance of controlling inflation has been more generally recognized. Although we have yet to face the issue squarely, at least some attempt has been made through monetary policy to discipline inflationary demands on the economy by consumers, business, and government.

Monetary policy, however, has been given little support in the form of fiscal and other measures to balance the three policy goals. During a prolonged period of rising prices, labor became accustomed to very substantial annual increases in money wages, and a vicious form of wage leadership has developed among union leaders. Annual wage demands have replaced, in a sense, excess liquidity as the prime generating force of inflation.

In our tax policies we have shown little recognition of the effects of the tax structure on economic progress. Expediency rather than rational choice seems to have dictated tax policy. Each year additional spending requires more and more revenue and tax reform is forced to take a back seat. Punitive marginal rates of taxation discourage investment, create inefficiencies, and restrict the mobility of capital. It is quite possible that uneconomic tax laws have been a major factor in the poor showing we have made in productivity gains during the past 2 years.

In sum, postwar experience, even most recent experience, does not provide convincing evidence that as a nation we have really accepted price stability and economic growth as policy goals on a coordinate level with high employment—much less learned how to reconcile the three goals in public policy measures.

Question 7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

To assess the impact of current Federal, State, and local government spending on the economy, is a large question which cannot be answered in short compass. For purposes of a summary discussion, government expenditures can be grouped into three major categories:

(1) Purchases of goods and services from the private business sector;

(2) Purchase of the personal services directly (government employment);

(3) Transfers of income from one group to another.

The first and second kind of expenditures are both income-creating and income-absorbing.

When the government spends to buy goods and services it adds directly to total demand for the output or product of the economy. Part of these expenditures go to buy military and civilian goods and supplies from private industries. As such they create jobs and income for the private sector of the economy, but they also use or absorb resources and output that might otherwise be available for production and consumption (or use) of private consumer goods and capital goods (producers' goods).

When the government spends to buy the personal services of government employees it also creates jobs and incomes directly, but here also it diverts labor away from possible private employments.

In a market economy, production and employment respond to demand. When the government spends on goods and services, this action considered by itself raises the level of total demands on the economy, stimulates increased output and raises total money income. If the economy is already operating at a high level of employment, additional government demand, not offset by a reduction in private demand, will be inflationary—will merely bid up prices and money incomes without increasing real output. But if unemployed resources exist (unemployed labor and excess capacity), an increase in government buying will usually increase both money incomes and output as unemployed resources are drawn into production. Even in an underemployed economy, however, increasing government spending may also raise prices with little increase in employment and output. This will happen if most of the spending is directed toward industries where there is little or no excess capacity or to segments of the labor market where little unemployment exists. Hence, it is important to realize that the income and employment creating potential of more government buying depends not only on the volume, but also the direction of the increased expenditures, as well as on the existing level of economic activity.

In addition to the direct income creating effects of government purchases, changes in the level of government spending produces secondary or induced changes in the level of private spending. An increase in new income created by government spending makes possible some additional consumer purchasing which stimulates still further increases in private spending and payrolls until the process of adjustment is completed.

Of course, reductions in Government spending work in the opposite direction. Such reductions decrease total demand both directly and indirectly. Hence, during periods of inflation, curtailment or postponement of Government buying helps to damp down inflationary pressures by keeping total demand within the system's physical capacity to produce.

Obviously, today, Government spending on goods and services is an economic variable of major importance. In the forseeable future the Federal budget will remain large in relation to the economy as a whole, to say nothing of the increasing demands made by State and local governments. To be sure, "waste" will always be a problem which can be kept within bounds only by constant hammering of public opinion and generalized pressure for "economy" in the use of

public funds, but Government budgets are large primarily because people, rightly or wrongly, demand (or appear to demand) a large volume of services, defense and others, through the agency of Government.

Of the many problems raised by big government, two are singled out here for special comment:

(1) The combined impact of Federal, State, and local spending on the economy is so great, that we cannot afford "bull in the China shop" fiscal policies. Government budget considerations cannot be confined solely to governmental activities, but must include the economic health of the Nation and how it is affected by Government fiscal policy. At least we must take care that Federal spending policies do not magnify and accentuate fluctuations in the level of private business activity.

(2) As the Government sector of the economy has grown in relation to the private sector, there is a growing usurpation of the discretionary right of the consumer to use his income as he sees fit. In the public sector choices must be registered through the political process rather than through the market place.

Public services are not subject to market evaluation and control. They have an irreversible quality which is unresponsive to changing economic circumstances, consumer preferences, and technology. There is no discipline of the profit and loss statement. For this reason, as the public sector of the economy grows as a proportion of the whole, less and less is the economy subject to consumer sovereignty and market pressures; therefore, it is likely to become less and less efficient in the use of resources.

The third category of Government spending—transfers of income—also has important economic effects. In modern times these so-called "transfer payments" constitute a large and growing segment of Government expenditures. Transfers really represent a redistribution of incomes. In making transfers, the Government does not purchase goods or services, but merely takes money from one group, or taxpayers generally, and turns it over to other groups who then spend it (or save it). In some cases, the original taxpayer may receive his own contribution back, fully or partially, as the beneficiary of such transfer. Anyone who receives interest on a Government bond, for example, pays all or part of his own interest income when he pays his taxes.

Most transfers are made according to statute for some real or imagined social purpose; e. g., veterans' benefits, unemployment compensation, social security benefit payments, relief, farm subsidies, and the like. At the Federal level, some are handled through trust fund arrangements and others through the budget proper (but not all trust fund expenditures are transfers; some trust fund outlays are used to buy goods or services).

In 1929, Government interest and other transfers at all levels of Government—Federal, State, and local—amounted to $1.9 billion, 2.2 percent of the national income. In 1957, such transfers amounted to $25.9 billion, or 7.2 percent of the national income—a considerable growth in both real and money terms.

Obviously, transfers of such magnitude do have important economic effects, but they are difficult to evaluate. It is usually argued that transfer payments tend to change private spending-saving habits

since under our progressive tax system it is presumed that tax receipts come from higher income groups with lower consuming propensities, while the transfer payments are received, primarily, by lower income recipients who have a higher propensity to spend on consumer goods. More of the income going to higher income groups who save at higher rates, it is argued, tends to find its way into investment expenditures for capital growth, while if the same income were diverted to lower income groups, more of it would be spent on consumption. It is easy to point out that in many cases the reverse situation exists. Interest payments may go to higher income groups who own proportionately more Government securities. Farm subsidies go to the prosperous large-scale farmer. Social security payments may be made to individuals with large investment incomes, and other examples could be cited.

Whatever the long-run impact of saving-spending habits of the country, there is no doubt that changes in the level of transfer payments do exert considerable influence on the level of total demand, since the amount of such transfers in a given period of time are not necessarily related directly to tax collections of the same period. In periods of declining national income (and tax revenues), many transfers increase, e. g., relief payments, unemployment compensation, and the like. These transfers keep private disposable income from falling as rapidly as national income, and thereby keep consumer spending from declining as much or as rapidly as would otherwise be the case. Conversely, in periods of prosperity, when national income (and tax revenues) are rising, these same transfer payments decline. As a result, disposable income and consumer spending do not rise as fast, and inflationary pressures are damped somewhat as a result.

Much has been said in recent years of the effectiveness of transfer payments as cyclical cushions, though their importance has probably been somewhat exaggerated. But it is still true that they do make our economy more "shock resistant" and thus make normal economic adjustments less dangerous.

There are other ways of grouping Government expenditures for purposes of assessing their economic impact. Some expenditures are really investments in productive forms of "social" capital—highways, schools, etc. Others represent current operating costs of necessary governmental activities. Still others represent pure waste—unwanted or unnecessary Government programs which divert resources from private use to no good end. Even necessary Government activities carried on at excessive costs are partially wasteful and, therefore, to a degree, a drain on the economy in terms of possible additions to output which are not realized on their account.

There is, unfortunately, a great predisposition on the part of the public and Government officials to overload the economy with all sorts of demands without regard to the real costs involved. Government services are not free, their real cost is the private production and consumption which must be sacrificed.

Our tax system is partly responsible for this state of affairs. Each group wants something, thinking that someone else will pay. Overloading the economy, while overlooking the costs simply imposes a cruel tax of inflation. As a nation, we cannot escape the costs of this overload.

Question 8. Give your opinion of the effect on our economy of current Federal, State, and local taxation.

Our present combined tax system—Federal, State, and local—is chaotic and, in many ways, most uneconomic. At the Federal level, we have a hodgepodge of indiscriminate excises, punitive corporative levies and confiscatory personal income and estate taxes. This system is superimposed on a multifarious structure of State and local taxes. The combined result is a conglomerate tax system which defies description or commonsense. A rigorous evaluation of its economic effects is next to impossible.

Certain features of the tax system, however, do stand out so sharply as to permit some general observations. There can be no doubt that the present tax system, in aggregate and in detail, seriously affects the performance of the economy and the pattern of economic growth. It capriciously changes the allocation of resources and distribution of income. It affects the volume and direction of private investment and almost dominates methods of business and personal finance. It changes the structure of industry and the pattern of regional development. It limits the diversity of job opportunity and penalizes efficiency. In short, it is an irrational system.

The present corporate income tax is uneconomic for several reasons. Ultimately, it is paid for by the consumer and the stockholder in the form of higher prices and lower rates of growth than otherwise would be possible. Its discriminates unfairly against equity financing in favor of debt financing. It penalizes efficiency and encourages wasteful expenditures. The 52 percent rate discourages marginal or risky undertakings and narrows investment opportunity. In addition, because of differences among industries as to composition and durability of capital assets, it unfairly discriminates against those industries having to make continuously heavy outlays for replacement of depreciable assets.

Progression in personal income tax rates is carried to ridiculous extremes at the upper end of the income scale. The small revenue yield from high surtax rates is purchased at great cost in the form of disincentives, public and private resources devoted purely to tax compliance and avoidance, and restricted investment opportunities. Such tax features cannot be justified on the basis of equity or economics. They represent an attempt by the electorate to "get something for nothing" and probably do more damage to the low-income groups in real terms than to those in higher income classes.

High personal rates are also an especially onerous burden to small business. Traditionally and potentially, earnings are the most important source of new capital for growing, small enterprises. High and highly progressive personal rates not only penalize success and efficiency, but expropriate the major source of new flows of equity capital to small business. It is a ludicrous posture on the part of the Congress to be piously devising all sorts of schemes to help small business when the Congress, through tax policy, is one of the chief causes of its plight.

Federal excise taxes now in force are highly discriminatory. They are the prolonged result of "temporary" wartime revenue measures. Transportation and communications taxes, especially, distort the flow of commerce and change the structure of industry. To the extent that

excises belong to a well-balanced tax system, they should be very low rate, broadly based, and nondiscriminatory.

At the State and local level, tax systems are largely conditioned by insatiable demands for revenue by the Federal Government. Although property taxes still form the backbone of local systems, State and local needs cannot be met from this source alone. Moreover, individual localities and States are limited in their tax autonomy by what other governmental units do. Under such circumstances, in the competition for tax sources, the Federal Government has an undue advantage. In addition, the Federal Government has reached down to tax purely local activities and functions—poolhalls, cabarets, local telephone service, etc. As a result, the system as a whole departs more and more from accepted economic principles of taxation.

State and local tax excesses are largely self-correcting. The costs and benefits of governmental services are more clearly evident to the electorate. And uneconomic taxes show themselves clearly in the results—migration, slow rates of growth, etc.

Those who are addicted to our particular form of federalism with its emphasis on local autonomy, responsibility, and diversity, cannot view Federal encroachment and tax usurpation with any degree of equanimity.

Clearly, the time has come when we should establish certain principles of taxation at the Federal level, and rid our tax system of those features which, in the long run, work against balanced economic growth and against federalism as we know it.

Question 9. Will you distinguish between fiscal policy (embracing expenditures, taxes, and debt) and monetary and credit policy, and then relate them, one to the other. Please discuss these policies stating how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

Fiscal policy is compounded out of the expenditure and taxing activities of Government and the considerations which go into determining spending and taxing plans. On the spending side, both the volume and the kinds of expenditures must be considered, just as on the tax side both the kinds and rates of taxation are equally important. The Congress ultimately has the unshiftable responsibility for fiscal policy.

Monetary policy refers to the activities of both the Treasury and Federal Reserve officials which affect the money supply and the terms of credit and other loanable funds. Generally speaking, the Federal Reserve Board and the System has the responsibility for carrying out monetary policy. In discharging this responsibility, it has three major tools of control by which it can ease or tighten the monetary and credit conditions:

(1) Changing rediscount rates at which member commercial banks may borrow additional reserves; (2) changing the required reserve ratio for member banks within legal limits, and thereby increasing or decreasing the actual or potential lending capacity of the commercial banking system; and (3) buying or selling Government securities in the open market and thereby increasing or decreasing total bank reserves and the lending capacity of the banking system.

Debt management represents a marriage of monetary and fiscal policy and is inseparable in practice from either.

The main issues in the continuing debate over stabilization policy arise out of differences in opinion and judgment as to the combination of fiscal and monetary measures which are feasible and desirable in light of prevailing or anticipated economic conditions. Theoretically and practically, it may be possible to achieve a full employment level of aggregate demand in a variety of different ways. Furthermore, to complicate matters, fiscal and monetary operations react and interact upon one another, making it difficult for the nonspecialist to see through the maze of complications which beset officials charged with policy responsibilities.

In the final analysis, the major policy questions must be resolved through the political process wherein there is considerable room for legitimate differences of opinion, both as to the ends to be served and the means to be employed. The sources of disagreement are chiefly these:

(1) Granted that a high overall level of output and employment and a fairly stable general price level are desired, how would the composition of total output be affected by different combinations of monetary and fiscal measures? One combination will expand governmental output at the expense of private investment and/or consumption. Another will favor private investment at the expense of consumption or vice versa. Some are more conducive to more rapid economic growth than others. And so it goes. Only the naive or tyrannical will petulantly or arrogantly demand conformity to his set of values.

(2) Given the impossible—an agreement on ends or values—what kinds of measures are most efficient in promoting those ends? This is a matter of understanding and judgment. There are numerous and serious practical problems in manipulating fiscal policy to achieve stability of demand. These are well known but often forgotten. Monetary policy, too, has its limitations, some of which are pointed out below. Unnecessary confusion often develops because proponents of different sets of policies fail to make clear when they are talking about values related only indirectly to overall stability and when they are expressing judgments as to the efficacy of different means.

(3) What do prevailing economic conditions portend? Even when limited agreement is achieved on matters of ends and the efficacy of means, there will always be differences in judgment as to the correct interpretation of current economic events. The old question of forecasting need not detain us here. Suffice it to say we cannot know the unknowable or the unforeseeable. Uncertainty, itself, confers certain differential advantages and disadvantages on various policy combinations.

(4) Finally, how can agreement be reached when economic understanding is lacking and misunderstanding can be used to private or political advantage? There will always be vocal, worried people who do not know what could or should be done, but demand "some kind of action." Some are aware of their limitations; others are not. They may genuinely believe not only that inconsistent aims can be achieved simultaneously, but, also, that there are simple unobjectionable ways of reaching them.

Fiscal and monetary operations are inextricably related. Spending, taxing, and debt transactions all affect the money supply. Indeed, Government fiscal activities are part of national monetary

policy, viewed in a broad sense. As potential stabilizers, monetary and fiscal operations or both complementary and competing, depending on the circumstances and the social goals which loom beyond the issues of economic stability. The brief discussion which follows is intended only to show how various poliices are related, not to espouse particular policy combinations or doctrines.

(1) In a sense, fiscal policies determine appropriate monetary policies and vice versa. During inflation, a reduction of Government spending reduces total spending on output directly. Such cuts, therefore, reduce the amount of monetary pressure needed on private spending needed to keep aggregate demand within noninflationary bounds. At the same time, higher taxes curb private spending directly by absorbing income and shrinking the money supply. Indirectly, tax hikes also depress the demand for investable funds by lowering expected net rates of return on investment projects and raising interest costs.

In the opposite situation, recession, increased Government spending, and lower taxes both operate in converse manner to increase demand directly and indirectly in both the public and private sectors.

In both instances, fiscal policies complement or reinforce monetary policy. Looked at another way, credit restraints during inflation would not have to be as stringent, or credit ease during recession would not have to be carried as far as would be the case in the absence of reinforcing fiscal policies. Some observers feel strongly that by the judicious use of appropriate fiscal measures, monetary policy would carry a lighter burden and some of the criticisms as to its uneven impact and adverse influence on the structure of industry could be avoided.

If monetary policy can be supplemented by fiscal aid, the reverse is also true. Those who advocate a greater reliance on fiscal measures must realize that to have maximum effectiveness, fiscal policies require cooperative monetary arrangements. In fact, the hoped-for results from stabilizing changes in Government spending and taxes will not come to pass unless monetary authorities permit an expansion of the money supply or restrict its growth as the occasion may require. Changes in the velocity of money, to be sure, must be taken into account, but in the main, the above generalization is substantially correct.

(2) Monetary and fiscal measures have competing aspects. In a sense, these may be more apparent than real, since the combination of policies selected should reflect a social consensus as to the composition of output as well as the desired level of output.

In some cases, monetary and fiscal policies may appear to conflict and be working in opposite directions—one stimulating and the other depressing. Monetary policy is more quickly reversible as economic conditions change and will usually lead ad hoc fiscal measures. At other times when, for other reasons, changes are being made up or down in the level of Government spending and taxing, monetary policy might be used to offset or soften transitional effects as a stabilizing procedure. In other cases, apparent conflicts merely represent a more complete integration of the several kinds of stabilizing procedures. For example, if it were desired to cut inflationary pressures without curbing exuberant growth, Government could drastically cut spending, raise personal income taxes, especially on the great mass of income

receivers, while the monetary authorities followed an expansive monetary policy. Or to take another hypothetical example for illustrative purposes, during a recession the Government might drastically reduce personal taxes to encourage immediate consumption at the expense of private investment and home building with monetary authorities cooperating to keep credit fairly tight, even in the face of a business contraction.

Monetary and fiscal policies do conflict when they work at cross-purposes to bring about results that are not really desired by the public or the Government—when through lack of knowledge, political perversity, or hysteria, the right hand does not know what the left hand is doing or does not take into account what the left hand is doing. In reality, there is no such thing as "stabilization policy," but a combination of policies which may be consistent or inconsistent, rational or irrational, planned or coincidental, fortuitous or unfortunate—and no one is apt to be completely satisfied with the results. At least, we can strive to make public policy more rational, consistent, and truly reflective of the underlying values held by the individuals comprising the social organism.

(3) Fiscal and monetary policies actually merge in the cash and debt operations of the Treasury. It is impossible to tell where one leaves off and the other begins. Tax collections reduce the money supply and bank reserves, while Government expenditures increase the money supply and bank reserves. When the Treasury borrows, what happens to the money supply and bank reserves depends upon who buys the securities (who lends the money); and when public debt is retired, the monetary effects depend on who holds the securities (to whom repayment is made). Even debt funding operations are not neutral. Quite different changes take place in the money supply, bank reserves, and the interest rates when refinancing changes the structure of the debt—the kinds of debt instruments, maturity pattern, interest rate pattern, and the ownership distribution of the debt among nonbank lenders, commercial banks, and Federal Reserve banks. All Treasury transactions have important repercussions on monetary policy.

Debt management issues have been covered elsewhere in this statement. Suffice it to say here that the Treasury can undermine or offset monetary policy by debt policy, and the exigencies of debt management create conflicts between appropriate monetary action and the opposite kind of Treasury action. This has been an acute, continuing problem since World War II, because of the legacy of a large public debt.

Nowhere are the conflicts in stabilization policies more acute than in the debt management field. Because of the large floating debt—short-term debt and other debt falling due within 1 year—the Treasury must be in the money market almost continuously to reborrow and refinance. During periods of credit restraint (inflation), the Treasury must pay higher interest rates. But this raises great political outcry because higher debt service charges add to the budget. Some legislators and private citizens demand "easier money" (and potentially more inflation) to "save" a few dollars on interest charges—even though inflation would drive up other governmental costs and rob the public in other ways through higher prices in the private sector.

Ideally, debt management could play a positive role in stabilization policy. During inflation, the Treasury could fund from short- into long-term securities, even though the cost of debt service would be increased. This process would work in the same direction as credit restraint, divert funds from private spending, and reduce private liquidity. During the recession, for example, the Treasury could fund from long- into short-term securities. This action would ease credit, release capital for private use, and help meet the public's demands for greater liquidity.

As we now conduct our debt policies, they not only do not aid stabilizing monetary policy, but load it down with additional burdens. Perhaps, this is as it should be. Some would argue that the Treasury should deliberately follow a policy of long-term funding during recession when interest rates are lower and avoid long-term funding during times of inflationary higher rates. According to this view, the Treasury should attempt to keep the interest service charges in the budget as low as possible without creating an impossible continuous funding problem. Under such circumstances, the Federal Reserve authorities would, then, take such Treasury action into account by following a more vigorous policy of credit restraint during inflation and a more plentiful easy-money policy during recession than would be required if the Treasury followed a countercyclical debt policy.

In fairness, it must also be pointed out that to use debt policy as a positive countercyclical device, presupposes a Federal debt with some manageable maturity pattern spaced out over time. Because of the awkward pattern which now exists, Treasury officials are almost forced to fund "as they can" without regard to burdens imposed on the Federal Reserve credit policies. Over the years, if the debt can be stretched out to give the Treasury breathing space, stabilizing debt policy may have some promise—provided the Congress also develops a more rational attitude in these matters.

(4) The statutory debt ceiling is another disturbing element in the fiscal-monetary environment. In spite of the fact that Congress must both appropriate money for spending and levy the taxes to raise revenue, it maintains a statutory debt limit to discipline itself. But when the public debt is continuously bumping against the ceiling, serious problems are created; not only are the prospects of flexible fiscal policy seriously weakened, but the goal of reasonable economic stability is placed in jeopardy.

In a business downturn, a budget deficit will surely arise even if the Government does nothing. What is to be done when tax receipts fall and the Treasury cannot meet its obligations? Should the Government add to economic woes by raising tax rates and postponing payments? It is a foregone conclusion that Congress will be forced to take action to raise the debt ceiling to avert financial crisis.

Defenders of the debt limit rightly fear uncontrolled fiscal license. To the extent that the debt limit makes it easier for legislators and administrative officials to resist pleas from special interests and Government bureaus for more and more spending, it probably has some merit. On the other hand, it may be doubted whether the debt limit itself helps very much to control inflation. Debt retirement is highly desirable during an inflationary boom at which time budget surpluses are available, and the debt limit by itself exerts no discipline on spending. Furthermore, current spending in any period is, in large

measure, determined by past congressional decisions—decisions which later bring a converging stream of claims on the Treasury which may exceed current revenues and the debt limit. When this happens, the credit of the United States or the debt limit must give way, and there is really no choice in these alternatives.

Ultimately, the will to resist irresponsible spending must come from a desire to prevent inflation and to keep governmental activities within their proper sphere. To be effective, Congress must exercise foresight, rather than hindsight, and be willing to face the future inflationary implications of current action. To place the emphasis on a rigid debt ceiling places the line of defense where it cannot be very effective, and at the same time it may unwisely restrict the use of appropriate fiscal policies during a recession.

Finally, as has been pointed out elsewhere in this statement, no combination of monetary and fiscal policies can be completely effective in controling long-run secular inflation unless something is done to correct the wage-price rigidities of the labor and product markets to which those policies are applied. That we have rising prices even during recession attests eloquently to the truth of this assertion. This does not mean that we should abandon attempts to achieve stability via appropriate monetary and fiscal policies. On the contrary we should recognize their limitations and set about to improve their effectiveness by correcting the monopolistic market structures through which all monetary and fiscal policies operate.

Question 10. Omit.

Question 11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy?

Prices are normally thought to rise during a boom and fall during a recession. However, if upward pressures on costs are strong enough and not readily reversible, prices may not fall and may even rise in recession.

Here briefly are the conditions and pressures affecting consumer prices which can produce an inflationary recession:

First, in well-unionized industries, substantial money increases are granted. Union leaders compete with each other or follow each other in getting more—more than existing prices can bear. In addition, wages will rise substantially in many industries on the basis of existing contracts previously negotiated. With the trend to 2- and 3-year contracts, wage increases cannot be postponed even in the face of failing demand.

With wage rates rising, costs will also rise unless wage increases are offset by increases in physical output per man-hour. In recent years, money wage increases and fringes, on the average, have tended to be approximately twice as big as can be absorbed by improvements in productivity for the economy as a whole.

Also, we can expect a spillover of wage demands into the service and trade industries in response to the large wage bargains in the strategic industrial sector. In fact this spillover should, as a matter of equity, occur to preserve some valid relationship in wage-rate differentials. But in the services possible productivity improvements are somewhat limited. Therefore, rising wage costs are not offset by spurts in productivity. The prices of services with their high labor content have risen year after year, come war, prosperity, or recession,

as an examination of the consumer price index components will readily show.

Thus it is that in a recession we have the twofold impact of (*a*) falling demand and (*b*) continuously rising costs.

In such a situation, one cannot predict precisely how prices will be affected. Where costs are rigid or shift upward at the same time that demand is shifting downward, anything can happen to prices. For the economy as a whole it becomes perfectly possible for recession and a rising consumer price index to occur simultaneously.

Question 11. (b) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

It has not been proven that we face a "lady or the tiger" decision between a seriously creeping inflation or a politically intolerable level of unemployment.

It is true that as the economy approaches high levels of unemployment, upward price pressures grow. We then face a choice in public policy between approaching further toward a perfectionist level of full employment and the maintenance of a stable price level.

Whether or not we fail to maintain the purchasing power of the dollar depends, in the last analysis and with all types of policies considered, on how strictly we interpret the goal of "full" employment.

If we set our employment goals too high in this regard, we will probably have to accept an inflationary creep with all the dangers of that growing into a gallop and runaway inflation. The dangers of this policy seem too clear.

The Employment Act refers to "maximum levels" of production and employment. The word "full" was deliberately avoided by the Congress in writing that act. If we permit some flexibility in our goal of high-level employment, and if we do not follow fiscal and monetary policies which have a systematic inflationary bias, and if action is taken to correct labor-market practices which generate a continuous upward thrust on costs, it should be possible to preserve the purchasing power of the dollar.

In short, we should not accept a gradual inflationary trend as desirable or even necessary. Until we have exhausted efforts to meet the problem, we should pursue policies which assume the existence of a zone in which we can have both adequately high employment levels (with elbowroom necessary for market adjustments) and adequate price stability (with flexibility in individual prices and probably some flexibility in general indexes).

Question 12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy.

Debt may be either a curse or a blessing for both debtor and creditor—depending on the circumstances.

A rapid growth of private debt or an abrupt decline of borrowing and lending can and do have serious unstabilizing effects on the economy. An excessive reliance on debt for long-term financing of private capital investment also has serious implications for stability.

The fact remains, however, that we live in a debt-credit economy. Debt performs essential and important economic functions. It is the financial manifestation of the time dimension in the economic processes of our highly specialized exchange economy. It is used as one vehicle

by which money savings are continuously channeled back into productive activity. It provides mobility of capital and thereby permits more effective use of our resources. It permits consumers to smooth out time patterns of consumption. And it is an essential ingredient in the process of economic growth.

While we have had a great growth of private debt in the past decade, we do not appear excessively debt ridden by historical standards. Private debt is a much smaller segment of total debt that it was in 1929 (largely because the public debt has loomed so large). In terms of the gross output of the country, private debt is relatively smaller than in any year prior to 1941. Per capita private debt is much higher in dollar terms than in prewar days, but lower in terms of current income. Net corporate debt per dollar of profits is not high by historical standards. Personal debt, to be sure, has risen markedly in postwar years as a percentage of disposable personal income, but the patterns of consumption have also changed, and for several reasons personal income is much more secure than it used to be in prewar days and earlier.

These observations are not intended to minimize debt problems, but to put them in perspective. In aggregate, the growth of private debt in recent years does not pose serious economic problems. Much more important is the composition of the debt, how rapidly it increases, what internal shifts take place, and the income-liquidity foundations under debt.

As long as we have a flexible debt structure in terms of time pattern of maturities, degrees of liquidity, forms of debt instruments, and the like, major shifts in the community's desire to change the composition of assets holdings can be accommodated without collapsing the whole structure and disrupting economic life. From the standpoint of flexibility and liquidity, our private debt structure appears to be much more safe and potentially much less dangerous to stability than was the debt situation which existed in the 1920's.

Two questions of the private debt situation, however, should be examined carefully:

(1) To what extent has private debt been incurred on uneconomic ground as a result of Government action? In the interest of stability we want the growth of debt to take forms which can be adequately supported by reasonable expectations of future flows of income. Moreover, we want particular debt excesses to be continuously self-correcting so as to minimize the dislocations and repercussions on the rest of the system when defaults or changes occur in particular segments. Capricious intervention by Government in credit and debt markets may in itself be a disturbing element which jeopardizes overall stabilization policy. A comprehensive study of the many leading-guaranty activities of the Federal Government would be necessary to assess the economic effects of such programs.

(2) How does our tax system affect private debt relations and our capital structure? From the standpoint of stability (and for many other reasons), a broad-based, diversified flow of venture capital in equities, is much to be preferred over long-term debt financing of investment. Yet we continue to put up with a tax system that discriminates seriously in favor of debt capital. Minor dividend credit on personal income taxes is no real solution. In any serious effort

at tax reform we should eliminate those features of our tax laws which encourage private indebtedness and favor debt financing by business over equity financing.

Question 13. See responses to questions 9 and 17.

Question 14. How much of a factor, in your opinion, has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

Deficit spending since World War II has not been the chief cause of postwar inflation, but deficit spending during World War II was, without doubt, the biggest single cause of the immediate postwar inflation—especially rapid increase in prices during the period 1945–48.

During World War II Federal deficits greatly inflated the money supply. In addition, wartime borrowing from the Federal Reserve System and commercial banks added greatly to bank reserves and the lending capacity of the banking system, and thereby made possible a further increase in the money supply by a multiple expansion of bank credit.

During the war the inflationary effects of deficit financing were partially suppressed by price controls and the public's willingness to accumulate cash balances and other liquid assets because of the unavailability of goods. After the war, as is well known, the public began to use the inflated money supply more actively to finance previously deferred demands. Starting from a highly liquid postwar base, the velocity (or turnover) of the supply of money increased steadily (with only a minor pause) through 1951.

Indirectly, the wartime deficits contributed in another significant way to the postwar inflation. The legacy of a large Federal debt and its mismanagement put severe strains on monetary policy which otherwise could have been more vigorously used to damp down the explosive inflationary fires. Until the Treasury-Federal Reserve accord of 1951, monetary policy was directed at keeping interest rates low on Government securities rather than curbing inflationary credit expansion. In order to help the Treasury with the uncomfortable task of debt refinancing, the Federal Reserve supported the bond market at the expense of the public at large. In short, the exigencies of debt management forced an easy money policy onto the country at a time when the supply of money was already dangerously inflated by the wartime deficits which produced the large debt in the first place.

During the Korean war, Federal deficits were less inflationary; they were partially offset by a more vigorous monetary policy which the accord of 1951 made possible. The largest deficit did not occur until 1953, by which time the major inflationary pressures had been brought under control. Even so, the money supply grew substantially and the velocity increased rapidly during this period—especially during the years 1951–52.

It should be pointed out that rapidly rising Government expenditures, even though covered or nearly covered by taxation, may create excess demand and inflationary pressures. Given our present tax structure, inflation of prices and incomes increases tax revenues more than proportionately and helps to cover growing Government expenditures. To be sure, such a process also raises the costs of Government, too, but where there is a lag in Government spending, deficits in real term may be concealed for a time by inflationary finance. In other

words, inflation may precede a deficit rather than follow it during a period of rapid mobilization when future commitments of Government are increasing sharply. In part, this happened during the Korean episode.

During the inflation of 1956–57 current Government deficits could hardly be made a whipping boy since cash surpluses were achieved in these years. There is considerable evidence and feeling among analysts that our more recent inflationary problems have arisen from wage-cost patterns which now grip us and from expansive private spending rather than governmental spending—a matter which we analyzed at length in The Mechanics of Inflation (1957). In this period the inflation was financed or "validated" by increases in the velocity of money, rather than by significant increases in the supply of money.

This is not to say that past deficits have played no part in recent inflationary experiences. They have—through debt management and the continuing influence of past deficits on the composition of the financial assets of the Nation. For example, short-term Treasury debt is highly liquid and serves as a "near money." It is doubtful if velocity of the money supply proper would have increased as rapidly if we had not had this great pool of liquidity in Government securities, and if Treasury debt refinancing had not kept the pool replenished.

Inflations are complex phenomena. Government deficits are only one element in a given situation, though, at times they may be the crucial element. Certainly, continuous deficits financed by central banks or the banking system will produce advanced inflation. Historically, nations have taken this route to avoid the hard political problems of honest public finance. Temporary deficits, of course, need not be inflationary if budget surpluses are also the rule in prosperous times. Even past deficits, however, may become inflationary subsequently unless monetary and fiscal policies are adapted to changing economic conditions. Fiscal discipline is the handmaiden of responsible government.

Question 15. Can full-employment goals be attained while maintaining a dollar that has relatively stable purchasing power?

Steps necessary to maintain a dollar that has relatively stable purchasing power may but need not jeopardize a reasonable goal of adequate high-level employment.

The pursuit of anti-inflation policy in Government activity will affect employment levels; to produce desired results there must be some employment effects. The issue arises over the degree of these effects and their implications.

This is a question on which further information and analysis would be useful. It is dangerous to make oversimplified generalizations in the absence of better evidence.

However, we believe that (1) there is no proof at this point that reasonable full-employment goals cannot be attained with a stable dollar and (2) that, lacking such proof, public policy should be pursued on the assumption that we can have both reasonably full employment and reasonably stable price levels.

Many argue that holding the line on the general price level will induce excessive joblessness. It appears to us that this is making

too quick an assumption on just where the inflationary threshold of the economy is. We believe that no one has yet, conclusively, demonstrated that successful prosecution of a sound anti-inflation policy involves intolerable levels of unemployment.

We should beware of undocumented statements that sufficient restraint must provoke recession of noticeable proportions. The reason: Such an assumption would, without question, produce public policies well calculated to foster further inflation.

As pointed out in the responses to questions 6 (*a*) and 11 (*b*), reconciling high levels of employment, price stability, and economic growth will not be an easy policy task. The pessimists rightly stress the inherent difficulties and our political weaknesses. The optimists attack the implicit premises of those who view creeping inflation as inevitable. They refuse to admit that the special features of our economic and political environment, which generate persistent cost pushes or produce inflationary biases, cannot be changed. The outcome will depend, in large part, on how important the public regards general price-level stability and our willingness to accept some normal fluctuations in both the price level and employment as a necessary and inevitable concomitant of economic freedom.

Question 16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

Widespread use of escalator clauses in wage and other contracts is good evidence that the public has little faith in the financial integrity of the Government or its ability to control inflation. General acceptance of the inevitability of creeping inflation will increase the demands for all sorts of escalators and accelerate the process. There is good reason to believe that they may be inimical to economic stability.

In some cases, escalator provisions may be accepted in lieu of higher wage demands and, hence, be anti-inflationary or less inflationary than wage contracts without them. But widespread use of escalators accelerates inflation, whatever its generating or initial causes may be. They reinforce inflationary pressures and create intolerable distortions in the distribution of income—with resulting divisive social strains. The more vigorously particular groups seek to nullify or minimize the impact of inflation on themselves, the more the unprotected groups suffer and the more persistent are the demands for equality—via, of course, more inflation.

Escalation for everyone would, of course, be self-defeating. It would produce runaway inflation and economic collapse. Paul McCracken, a present member of the President's Council of Economic Advisers, put the issue squarely, a few years ago, in these words:

"Price inflation is the way market forces endeavor to boil the surplus purchasing power out of the system. But if we set up escalator machinery by which as fast as the excess is removed it is promptly pumped back into the economy, the end result of a policy of slowly rising prices is certain to be prices rising not so slowly (Michigan Business Review, September 1955).

Question 17. List and briefly discuss what you consider the causes of the present recession and what should be done to terminate it.

The present recession, like most recessions, developed out of maladjustments of the previous boom and, in the main, represents the normal growing pains of economic progress.

Business cycles are complex phenomena. They cannot be discussed "briefly" or the causes "listed" in a very meaningful way. There are many theories of the cycle—most of them not incompatible. Different theories merely focus on different strategic variables, processes, or relationships. But there is fairly widespread agreement on the following:

1. Business cycles are primarily investment cycles.
2. Business cycles are intimately related to the process of growth.
3. Business cycles are inevitable and normal in a free economy. While widely deplored, they must be faced realistically. They cannot be eliminated, but they can be kept within a normal range of necessary self-adjustment of the system.
4. Because of their cumulative, self-reinforcing nature, there is always danger that business fluctuations may go beyond the normal readjustment and create new maladjustments. It is the task of public policy to prevent excessive inflationary and deflationary pressures from becoming cumulative, but public policy should not try to eliminate the cycle or prevent necessary market readjustments from taking place. As to what can be done about the current recession, the national chamber's position has been stated recently by its president, Mr. Philip Talbott, in a letter to Members of Congress. The text of the letter follows:

"You and your colleagues are vitally concerned with what the Government might do to stimulate economic recovery. The actions the Congress takes during the remaining months of this session could revitalize or might seriously weaken our Nation. I share this concern and would like to give you the benefit of our thinking.

"(1) The first line of defense, of course, is a flexible credit and monetary policy. Fortunately, the Federal Reserve System increased credit restraint as early as 1955. Since last November, it has relaxed this restraint, and the situation should be continuously reevaluated, as the Federal Reserve is doing, and additional steps should be taken by the Federal Reserve, if needed, to reduce the cost of credit and to increase its availability.

"In connection with monetary policy, the public debt should be so managed that it tends to increase the liquidity of the banking system and the economy during a period of softer markets, such as the present. As bank reserves and liquid assets grow, the pressures on their owners to put them to more remunerative use will help put a floor under recessionary tendencies, and this, in turn, will help to sparkle recovery and reemployment.

"(2) We already have a measure of built-in public-revenue flexibility in our income-tax system, so that tax liability drops more rapidly than income, thus leaving more funds in the hands of the taxpayer. Increases in Government spending in the form of unemployment compensation, relief, and the like occur automatically when unemployment rises. These, in a sense, constitute a second line of defense, and have already gone into operation without requiring Government discretionary policy decisions to buoy up the economy. They do not depend on any uncertain forecasting of the business outlook.

"(3) As a third major step, the Government already has accelerated a number of existing procurement and construction programs, such as in the case of highways, other types of construction, including mili-

tary construction, as well as military and other procurement. Steps to stimulate residential construction have been taken.

"(4) As a fourth step, the national chamber has recommended a tax cut and tax reform to provide greater incentive, both to buy and invest. Even though this will involve a short-run, temporary deficit, we think the growth which will be stimulated by such tax cuts and tax reforms will, in a short time, cause revenues to increase and again bring the budget into balance.

"The foregoing procedures or steps should be adequate to arrest the recession and allow normal recovery through necessary readjustments to take place. The wrong medicine or an overdose may do more harm than good.

"We have grave doubts about the wisdom of a massive Government construction program on a WPA, or PWA, or any other basis. The proposed Community Facilities Act of 1958 would be a case in point. Any such massive ad hoc program is exceedingly awkward, cumbersome, and slow, both in launching projects and terminating them when improvement has taken place.

"Furthermore, since it is so difficult to terminate them, the projects may compete for scarce labor and materials just when the recovery of the private economy is getting underway. This could slow down recovery and expansion. Upward cost and price pressures could stop such recovery in its tracks.

"The full impact of a massive public-works program would not be felt for, perhaps, as much as 2 years. Then, according to numerous prognostications, our military expenditures also will be rising still higher. The two programs would compete against each other for tax dollars and possibly for scarce resources. The Federal budget would build up to unprecedentedly high levels. This would not be in the public interest because it would generate inflation and defer further tax cuts and tax reforms.

"It does not seem wise to use the current situation as a device to promote long-range Government programs. To give every public spending proposal an 'antirecession' cloak, is an easy thing to do. To do so, obscures the fundamental choices which Congress and the voters must make—how the Nation's resources are to be allocated among private and public uses. Government spending should be determined on a long-range basis as to what services we really want Government to provide. Each spending proposal should be judged on its individual merits, and decisions made on that basis.

"For these reasons, we hope that Congress will not embark on any new, general public-works programs or other measures of doubtful effectiveness, and that you will do what you can to encourage a sound tax program and allow the other steps already mentioned to demonstrate their effectiveness.

"Your reaction to this line of approach will be appreciated."

Sincerely yours,

PHILIP M. TALBOTT, *President.*

NATIONAL COAL ASSOCIATION,
Washington, D. C., March 25, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR MR. CHAIRMAN: By letter of February 17, 1958, you transmitted to Mr. L. Newton Thomas, president, National Coal Association, a series of questions incident to your committee's inquiry entitled "An Investigation of the Financial Condition of the United States."

I am directed by President Thomas to transmit to you the enclosure which responds to selected questions. No attempt has been made to answer all of the subject matter inquired about.

Trusting these responses are of some benefit to you and the committee, I am

Yours very truly,

TOM PICKETT, *Executive Vice President.*

REPLIES TO SELECTED QUESTIONS PROPOUNDED TO MR. L. NEWTON THOMAS, PRESIDENT, NATIONAL COAL ASSOCIATION, BY THE SENATE FINANCE COMMITTEE INCIDENT TO AN INQUIRY ENTITLED "INVESTIGATION OF THE FINANCIAL CONDITION OF THE UNITED STATES"

(For convenience in presenting this material, the questions as numbered in the interrogatory are repeated and the answers follow)

1. Give a definition in your own words of deflation and inflation.

Deflation is a period of generally falling prices, with growing unemployment which is spotty at first and which then tends to spread throughout most of the economy. Inventories are high and production schedules are cut, due to decreased demand. Fixed-income groups benefit, while wage earners tend to lose. Consumers dip into savings and credit use generally is off, as debts are being liquidated. Taxes become increasingly burdensome to all.

Inflation is the opposite of deflation, though not necessarily due to the same factors. These developments characterize excessive rather than mild inflationary or deflationary movements.

2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

The best way to avoid excessive inflation or deflation is to allow business to operate with minimum restrictions. It is impossible to avoid completely all inflationary or deflationary movements, although it should be possible to avoid excesses. Our economy is too complex to expect neither. It is becoming increasingly difficult to transmit or communicate the forces of demand and supply to all areas of the economy. Some lag is inevitable, one of the reasons why we can have inflation and unemployment at the same time.

In theory, it might be possible to achieve a complete absence of either inflation or deflation, but this condition can be secured only through vastly increased Government controls of industry, thus placing our economy in a governmental straitjacket and just about bringing about an end of free enterprise. Current business restrictions, such as excise taxes, high corporate income taxes, and unequal tariff barriers, tend to prolong periods of inflation or deflation before normal economic adjustments can be effective.

Laws which are needed to improve the economic health and well-being of this country will be referred to in my answers to certain of your other questions. However, in connection with the overall economic situation, it might be advisable for Congress to establish an independent committee of economists, businessmen, and labor leaders to determine danger signs in the economy; to recommend necessary actions by Congress; and generally to exercise a type of economic stewardship. This committee should be composed of outstanding individuals and should be independent of control by any branch of the Federal Government. While the President's economic advisers and the great number of economists now employed in Government permit the Nation to acquire a cross section of the best economic thinking, a committee such as that suggested could have more prestige and exercise more influence than any agency constituted at present. There is some doubt that economists now in Government can ever be completely objective.

6. (a) Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy in the United States: (1) price stability; (2) stability of production, demand, and employment; (3) economic growth in production, demand, and employment.

(b) With respect to these three objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II, during the most recent 2 or 3 years, and especially since 1957.

With respect to the first part of this question, economic growth is the most important of these three objectives, though for the best interests of the country such growth must be orderly. Price stability and stability in production, demand, and employment are of course required; but "stable" should not mean static, but instead should mean a steady and even rise. Upward swings of the business cycle with rising prices and employment, as well as capital expenditures, are healthy as long as they do not get out of bounds. This Nation, however, cannot continue indefinitely on an upward trend without an occasional reversal. The role of Government should be to see that such reversals are readjustments and not recessions or depressions. Economic growth through expansion in demand creates new opportunities for investment and for capital expenditure generally. A climate of optimism exists and inflationary forces may or may not be effective at the time. A healthy growth in our economy is essential to meet the demands of growing population and our constant striving for a higher standard of living. It is doubtful that economic growth could develop without upward price movements. The danger, of course, is that inflationary forces may get out of hand. This is where the Government can be most useful to the economy.

The most important postwar trend, particularly in the last year or so, has been the narrowing of profit margins. Producers have had to contend with continued high taxes, especially the corporate income tax, and with revenues which have not kept pace with costs. The inadequacy of revenues has resulted from the mushrooming of competition since the war and the holding down of prices because of this. Suppose we take the bituminous coal industry as an example, the industry with which I am closely associated. Since the war the price of coal at the mines has increased very little. Through mechanization and economies we have managed to absorb increased wage and other costs. Yet increased freight rates and growing competition from other fuels has made it difficult to maintain profitable operations.

Undoubtedly a major factor in the present slowdown in capital expenditure has been the discouragement to investors and managements as a result of these same narrower margins. The businessman wants some assurance that rising cost and lowered margins will not become a permanent part of the business landscape.

An important characteristic of the postwar years has been the transition in business from service competition to price competition. The necessity for price competition has been an outgrowth of the very rapid postwar expansion in the capacity for producing consumer goods and durables. The rise of the discount house and the breakdown of the various fair trade laws are symptoms rather than causes of this new type of competition. Associated with it have been such developments as the growth of establishments which cut across many lines of distribution. Food stores in many cases are no longer simply engaged in the sale of food products. The automobile industry also has been increasingly characterized by price competition, as is evidenced by the discontinuance of many older agencies, chronic overproduction, and longer and longer credit terms.

A phase of the entire issue is the increasing acceptance by consumers of a multitude of credit plans for financing personal purchases. One of the major problems of our economy today is that of the use of credit. Increasing private debt, whether long-term or short-term, always presents a serious problem for the national economy when the amount of personal obligation reaches a high point relative to income. In inflationary periods, the consumer can expect his income to increase considerably if he is a wage earner. On the other hand, people with fixed incomes find it increasingly difficult to finance purchases either on credit or otherwise. Yet personal credit facilitation can become a boomerang, as in the case of the auto industry where a combination of extraordinary selling activity, almost completely new models, and easy credit, frequently running to 36 months, has plagued the auto industry and kept inventories high for the past 2 years. With so much of the economy depending upon the automobile industry for support, such "cheap" credit not only postpones other purchases during the time of its application to the individual, but merely delays the inevitable day of judgment.

7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

I shall confine myself to answering the portion relating to Federal Government spending, since this is obviously the most significant factor. Large Federal spending for the most part does not result

directly in the creation of consumer goods. Much of it is devoted to national defense and foreign aid. For this reason, I believe that such spending creates a strong inflationary tendency by withdrawing scarce resources, including labor, from the production of goods which the people of the United States need and want to buy. Tremendous Government spending also is generally inflationary because it is common knowledge that the Government is not a very good bargainer pricewise—that is, in making contracts it is very much inclined to overpay the producers of goods. Incidentally, if pump priming is used by the Government as a deliberate policy, I would assume that along with it would go a calculated effort to keep the prices of goods and services involved at high levels. Excessive Government spending is, in the long run, bound to be inflationary, I believe, since it is accompanied by a continually increasing public debt. The point will finally be reached (and I think it shows signs of being reached right now) where the Government, as a larger debtor, simply cannot afford to pay off the principal, or even the interest, in dollars having the same value which they had when the money was borrowed. Finally, the Government, in the postwar period as well as earlier years, seems to have adopted the view that continuing inflation itself is a good thing, or at least that it is preferable to a trend in the other direction. Even if the latter and more conservative view is made the basis of Government action, I think that inflation will result because of the tendency to overcorrect deflationary elements. In this connection, I think that the sharp upward trend of the stock market during the past few days, in the face of bad business news, clearly reflects a fear of inflation outweighing the fear of lower profits—in other words, a flight from the dollar. By both inflation and deflation is meant to excessive or abnormal trends referred to in my answer to questions 1 and 2.

8. Give your opinion of the effect on our economy of current Federal, State, and local taxation.

Here again I will confine my answer to the effect of Federal taxation. As between a rapidly increasing public debt and continued high taxes, I would consider the latter the lesser of two evils. At least it would lack some of the more important inflationary aspects mentioned above. At the present time, however, it appears that we unfortunately are going to have both a continuation of high tax rates and a marked increase in the public debt. There may be some relief in the form of an increased personal exemption, or even in the form of some slight reduction in rates across the board, but I do not think this will be of much significance in stimulating the economy to produce more goods. The sharply graduated tax on personal incomes is a very serious deterrent factor in the face of the obvious need for expansion of our economy. People who have money to invest find that a good deal of it is skimmed off by Federal taxes. Furthermore, there are a good many tax-sheltered investments, such as tax-free State and municipal bonds and funds of various types which can be taken advantage of by the really wealthy taxpayer. Obviously, the investment of money in these fields does not promote the growth of the economy.

Our industry is primarily interested in percentage depletion as a tax relief device. Contrary to popular opinion, percentage depletion is by no means a loophole, but is a perfectly proper and legitimate

tax deduction. This sort of deduction, in times of sharply rising costs, is in fact a good deal more equitable and realistic than the deduction for depreciation. The latter has been under sharp, and quite justified, attack recently because it is based on cost. The result is that the dollars recovered tax-free through the depreciation allowance are, in most cases, grossly inadequate to maintain the taxpayer's capital investment. Since depletion is measured by income, there is at least a rough adjustment of the amount of the deduction as the general price level rises. In the long run the depreciation allowance will have to be adjusted in somewhat the same manner, if the inflationary trend continues. But here again is a case where the Government simply cannot afford to do equity very quickly. The tax loss involved in putting depreciation on a replacement basis would be tremendous. Again, the matter of the effect of divergent trends on the economy is important, for under deflationary trends the tax gain here would be high.

The corporate tax rate is, of course, quite large. I believe, however, that this is not as serious a matter for the development of the economy as a whole as are the very high personal income tax rates. There is certainly a very good argument for reducing the corporate tax rate to 50 percent simply on the rough justice theory that the Government should be no more than an equal partner.

11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy?

(*b*) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

Inflation and unemployment can exist side by side. This is the result of the failure of economic communication. The automobile industry and certain other major businesses are experiencing unemployment while prices in many other areas continue to edge upward. It is possible to have unemployment in durable goods and inflation elsewhere in the economy. Much of the responsibility for this lies in the "stickiness" in the movement of prices. The credit system tends to keep prices up because people are still paying for purchases made in 1956 and 1957, when business was better by most standards. Until unemployment in the auto, steel, railroad, and other basic industries can transmit its effects to consumer prices generally, creeping inflation will continue to exist. A major reason for this discrepancy between prices and employment is the existence of easy consumer credit in virtually all lines of durable and soft goods.

With respect to the second part of this question, some inflation, as well as deflation, is inevitable in a free economy, assuming, of course, that this is what we have today, a conclusion with which I disagree. Gradual inflation is not the same as excessive inflation. The former is a natural part of any noncontrolled economy. The Government's role should be two-fold: To prevent excessive inflation, and to stand by with assistance, both direct financial and indirect through the reduction of taxes and other devices, when excessive inflation has brought about (1) unemployment, (2) a slowdown in capital expenditures, and (3) a retrenchment in industrial expansion plans. Capital outlays largely are due to expectation for increased demand for the products and services of industry. Part of this, of course, is mildly inflation-

ary. Again, as I have stated elsewhere, an increasingly dangerous factor in the national economy is the growing size of Government expenditures. The vast amount of public funds poured into the economy through this door prevents the free operation of economic forces which otherwise might bring about adjustments between inflation and deflation.

15. Can full employment goals be attained while maintaing a dollar that has relative stable purchasing power?

The answer to this is "Yes," if what is meant is "relatively stable." The American people certainly do not want instability. The Government should use every device at its command to see that a relatively stable dollar is maintained, curtailing unnecessary Government spending when times are good and increasing this when times are bad. This goal, of course, is less easily attained when defense needs are large. It is impossible to expect a smoothly operating economy when defense needs are as at present and in addition to this, large Government funds are being expended for a multitude of purposes, many of which should be carefully reviewed as to justification. The danger is, of course, that curtailment of nondefense needs in order to maintain a more balanced budget may mean postponement of such needs for a considerable time, as at least in the foreseeable future, there appears to be no chance for curtailment in defense expenditures.

17. List and briefly discuss what you consider the causes of the present recession and what should be done to terminate it.

The major causes of the current recession are:

(1) Excessive use of consumer credit, bringing about curtailment of consumer expenditures until current obligations are liquidated;

(2) Narrowing profit margins for producers and distributors, brought about in large part by increasing wages and other costs on the one hand and relatively fixed revenues on the other; and

(3) Heavy Government expenditures due in large part to defense needs but which have the effect of preventing free communication of economic forces on the operation of factors which would adjust our economy between excessive inflation and deflation.

Among the steps which should be taken to remedy the situation should be the following:

(1) Tax reduction—especially in personal income taxes, although it is important to reduce business taxes, probably to 50 percent or perhaps less;

(2) Elimination of excise taxes and other taxes which are only indirectly related to the basic purpose, or purposes, originally underlying their imposition. For example, the transportation tax should be dropped. It no longer is needed to discourage transportation either of passengers or of freight. If the tax on coal were eliminated, for example, the amount saved would equal the recent rate increase requested by the railroads;

(3) Adoption of a policy, publicly stated and fully implemented, for taking Government out of competition with business, and reduction of the Federal budget wherever possible;

(4) Affirmative action on the recommendations of the Hoover Commission on Economy in Government; and

(5) Establishment of a completely independent economic committee staffed with highly qualified business and academic leaders who would recommend to the Government desirable action concerning consumer and industrial credit and anti-inflation devices. The committee should establish an economic barometer, to be used as a warning of excessive inflation or deflation.

To summarize: The Federal Government has become such an important factor in our economy as a result of its spending programs, especially in connection with defense, that its actions tend to obscure normal trends in economic forces of demand and supply. Until Government participation is reduced to a minimum, private enterprise will continue to experience artificial inflations and deflations.

The bituminous-coal industry, representing the utilization of a natural resource, is particularly susceptible to such artificial stimulation, because coal, unlike many other industries, is a derived industry—that is, its success or failure generally depends upon the economic health and well-being of its customers.

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